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Introduction and Overview

No one can appreciate the advantages of a federal system more than I. I hold it to be one of the most powerful combinations favoring human prosperity and freedom. I envy the lot of the nations that have been allowed to adopt it.

Alexis de Tocqueville, *Democracy in America*

I should wish you to have as many [states] as you now have palatinates. Create in each of these states as many regional administrations. Perfect the organization of your dietines, granting them wider powers within their respective palatinates.

Jean-Jacques Rousseau, *The Government of Poland*

The probable evil is that the general government will be too dependent on the state legislatures, too much governed by their prejudices, and too obsequious to their humours; that the states, with every power in their hands, will make encroachments on the national authority, till the union is weakened and dissolved.

Alexander Hamilton, *Remarks in the New York Ratifying Convention*, 1788[1]

Alexis de Tocqueville was not alone. Federalism, especially the American variety, is one of the world's most admired and copied political innovations. Starting at least with Montesquieu, political philosophers have pointed out the advantages of decentralized, multilayered government structures and, at least since Rousseau, advocated their adoption in a wide variety of settings around the world. Tocqueville's enthusiasm and Rousseau's practical advice have been taken up with renewed vigor in the late twentieth century, as transitions from centralized authoritarianism to democracy in countries from Eastern Europe to Latin America and Africa have been marked by the decentralization of authority to state and local officials. Other than transitions to democracy, decentralization and the spread of federalism are perhaps the most important trends in governance around the world

[1] Frisch (1985: 220–21).

over the last fifty years. Even long-standing democracies like Spain and Belgium have chosen to adopt explicitly federal structures, and many others have transferred resources and authority to local governments. Moreover, the gradual evolution toward a European federation is perhaps the most impressive political project of our time.

All of these developments have been accompanied by great optimism about expected improvements in the quality of accountability, efficiency, fiscal discipline, and even economic growth. Yet even a cursory look at the history of federalism should give reason for pause. The U.S. federation has been torn apart by a bloody civil war and a legacy of regional and racial strife, and history's dustbin is filled with failed federations from ancient Greece to modern Yugoslavia and Czechoslovakia to the Caribbean. While civil wars and velvet divorces justifiably get a good deal of attention, federalism can also fail in another way that has, until very recently, escaped the attention of pundits and scholars alike. As this book documents, federalism can lead to spectacular debt accumulation and disastrous failures of macroeconomic policy.

The potential perils of federalism did not escape the attention of its most colorful historian and critic, Alexander Hamilton. His well-known fear, illustrated with copious historical examples from the Lycian and Achaean leagues to the German diet, was of a weak federal government falling prey to foreign conquest or internal dissolution. Much less scholarly attention has been given, however, to his related fears about fiscal federalism. Hamilton was very skeptical about the wisdom of giving the "power of the purse" to state governments. He feared not only that they would use taxing and borrowing powers to weaken the center but, more specifically, that they would spend and borrow excessively, attempting to shift their burdens onto the central government and one another. His fears were well founded: A binge of over-borrowing by a group of states in the 1840s led to macroeconomic instability and ruined U.S. creditworthiness abroad. Remarkably similar events involving the Brazilian states and Argentine provinces have recently led directly to debt crises and hyperinflation in those federations, with staggering social and economic costs. Related problems of federalism and fiscal indiscipline have shown up in a number of other countries, including India, Nigeria, Russia, and South Africa (see Rodden, Eskeland, and Litvack 2003). As this book will show, the problem of federalism and fiscal indiscipline is not limited to new democracies or developing countries. Relatively serious problems with borrowing by state and local governments can be documented in Germany, Italy, Spain, and elsewhere.

Tocqueville's enthusiasm for federalism has been echoed by philosophers, politicians, and economists throughout the nineteenth and twentieth centuries. Indeed, such rhetoric has only gained prominence since the 1970s, as a wave of decentralization spread across developing countries and the process of European integration moved forward. Though operations personnel have always been wary, policy discussions at the International Monetary Fund (IMF) and World Bank in the early 1980s often celebrated the advantages of decentralization and downplayed the dangers. Yet by the end of the 1990s, attention has turned from the theoretical advantages of decentralization and federalism to the realities of the Brazilian and Argentine crises, interprovincial trade wars, and growing recognition of problems with corruption and inefficiency among state and local governments and their public enterprises. Easily the most visible and vexing problem is fiscal indiscipline among subnational governments.

Virtually all cross-national empirical studies of public sector deficits and debt have ignored subnational governments. At first glance, this may not seem problematic; during the period from 1986 to 1996, the average subnational deficit was only around one-half percent of gross domestic product (GDP) for a sample of sixty-three countries. However, in eleven formally federal systems – which include several of the world's largest economies – average subnational deficits exceeded 1 percent of GDP and accounted for nearly 20 percent of total government deficits.[2] In some countries, like Argentina and Brazil, the aggregate subnational deficit routinely surpassed that of the central government and exceeded 2.5 percent of GDP, and subnational debt has reached 15 percent of GDP. Moreover, recent studies have shown that increasing subnational deficits are associated with higher central government expenditures and debt (Fornisari, Webb, and Zou 1998), along with higher rates of inflation (Treisman 2000a).

On the other hand, over the course of the twentieth century many countries – ranging from unitary countries like Norway to federations like the United States and Switzerland – have been able to keep state and local deficits under control or even run surpluses. In fact, federalism and fiscal decentralization are often viewed not as creating opportunities for fiscal imprudence, but rather as important bulwarks of fiscal discipline. This book is an attempt to answer a question of growing importance: What accounts for cross-country and diachronic variation in the fiscal behavior of

[2] Source: IMF, *Government Finance Statistics Yearbook* (various years), *International Financial Statistics* (various years), and author's calculations.

subnational governments and with what implications for the entire public sector? Why do some subnational governments appear to behave as fiscal conservatives, while others run up dangerous, unsustainable deficits ?

This book develops a set of arguments about the varieties of decentralization and federalism that go well beyond earlier studies that focus primarily on the overall level of fiscal decentralization or the mere presence of federalism, and as a result it has strong policy implications. Europe is going through a period of debate and negotiation on its constitutional future not unlike that undertaken in Philadelphia, and participants are keenly aware of the potential for fiscal indiscipline among constituent units in federations. Among others, the constitutional futures of long-standing federations like Argentina, Brazil, Germany, India, and Mexico are currently being debated, along with those of decentralizing countries like Belgium, Italy, and Spain. In each case, the issue of fiscal discipline is taking center stage. Thus, a systematic analysis of the relationship between decentralization, federalism, and fiscal discipline is a timely undertaking.

I. Promise and Peril

At the beginning of the twenty-first century, decentralized federalism is to political economy what Prozac is to mental health. Use is on the rise and everyone is talking about it, but some tout its extraordinary benefits while others insist that it just as often makes things worse. It is increasingly clear that the treatment has vastly different effects on different subjects, but no one knows how, why, or under what conditions it succeeds or fails. Abstract theories of federalism have claimed that fiscal and political decentralization can improve the efficiency and accountability of public sector institutions and even facilitate rapid economic growth. One of the most basic claims, first celebrated by Friedrich von Hayek, is that decentralization can improve the fiscal responsibility of government. On the basis of theoretical claims and some impressive success stories, decentralization has been prescribed around the world. Unfortunately, however, harmful side effects appear to have overwhelmed the expected benefits in a number of countries, and skepticism is growing. Like a controversial drug, neither the promise nor the peril of federalism should be accepted at face value until its effects have been assessed on a wide variety of subjects, each with different histories and preexisting conditions. By examining the problem of fiscal discipline, this book takes up that task.

The promise of federalism is a straightforward proposition that has shown up time and again in political and economic theory from Montesquieu to James Madison to Richard Musgrave: In heterogeneous societies, government policy is most likely to be aligned with the preferences of citizens in the presence of multiple layers of government, each charged with different responsibilities. Higher-level governments can provide federation-wide collective goods like common defense and free trade, while lower-level governments can provide goods like trash collection and religious education that will be consumed locally. If each layer of government stays within its bounds and respects the authority of the other, citizens can hold each layer of government separately accountable for its activities. While a single sovereign might be tempted to abuse its authority, federalism provides a valuable protection by dividing power among multiple, competing sovereigns. Political scientists view such divided sovereignty as a path to stability and peace in societies divided by strong linguistic or ethnic cleavages. Economists extol the virtues of preference revelation, information, and the benefits of intergovernmental competition. Both views boil down to increased responsiveness and accountability; decentralized, multitiered systems of government are likely to give citizens more of what they want from government at lower cost than more centralized alternatives.

The potential perils of federalism have received far less attention. Federalism is more than mere administrative decentralization. It implies that the autonomy of the central government is effectively limited, either by constitutional rules or less formal restraints. In fact, the accountability advantages of decentralization *require* that the central government's authority be substantially limited. Industrial organization theorists have shown that in order to strengthen incentives and promote initiative in a decentralized organization, the center must credibly limit its own information and authority. The flip side, however, is a loss of strategic control by the center. In decentralized federations, politically fragmented central governments may find it difficult to solve coordination problems and provide federation-wide collective goods.

As in the private sector, public institutions only produce desirable outcomes when incentives are properly structured. Decentralization within large, complex industrial organizations, for instance, clearly has the potential to increase productivity by giving division leaders greater flexibility and stronger incentives to innovate. But aggregate efficiency is only enhanced if incentive structures discourage division leaders from manipulating information advantages. Decentralization may be quite costly for the organization as a whole if it cannot safeguard against widespread opportunism. This book tells a similar story about borrowing in federations. Like a decentralized firm, a federation can be seen as a complex nexus of interlocking contracts. If these are not properly structured and actors are resistant to renegotiation, decentralized federalism might undermine efficiency and dilute democratic accountability, perhaps ultimately threatening the stability of the federation. In particular, state and local officials might face incentives to expand their expenditures while externalizing the costs to others, turning public revenue into a "common pool" that is overfished by provincial governments.

II. Federalism and Sovereignty

The next chapter starts by revealing a large gap between the dominant theoretical literature and the current trend toward decentralization around the world. The theory literature often envisions decentralization and federalism as essentially the same thing: a neat division of governmental authority into distinct, hierarchical spheres of sovereignty. From the classics of political philosophy to the modern economics literature, this notion of divided sovereignty plays an important role in the promise of federalism. After reviewing the existing theoretical and empirical work, Chapter 2 contributes more-precise definitions of decentralization and federalism than those employed in these literatures and presents a good deal of data drawn from countries around the world, painting a contrasting picture of murky, overlapping authority in which sovereignty is often unclear and contested. These observations create a fresh starting point for a political economy approach to multitiered government that is well suited to examining the diversity of types of decentralization and federalism, as well as the diversity of outcomes seen around the world.

A key insight of the book is that fiscal decentralization rarely entails distinct sovereignty for subnational entities over their debt. When sovereignty is unclear or disputed, actors use the information available to them and assign probabilities to the likely ultimate locus of authority in the event of a conflict. Sovereignty at a given time in a given policy area in decentralized systems is best understood as a set of *ex ante* beliefs about likely winners of future intergovernmental battles. Chapter 3 presents borrowing in a multitiered system as a dynamic game of incomplete information, where voters, creditors, and subnational governments have limited information about how the central government would react in the event of a future fiscal crisis. Subnational governments must make fiscal decisions, creditors lending decisions and voters electoral decisions, without knowing whether the central government ultimately guarantees subnational debt. If all actors have perfect information that the center is committed to a policy of never assuming subnational debts, it makes sense to view subnational governments as distinct, miniature sovereign borrowers. However, this book demonstrates that this is rarely the case. Most multitiered fiscal systems have evolved in the latter half of the twentieth century with institutional features that undermine the central government's commitment and hence the fiscal sovereignty of subnational entities.

To demonstrate how this game works in action, Chapter 3 examines the interaction of the U.S. states and federal government in the 1840s. The federation was still relatively young and had a recent history of debt assumption and rather ad hoc resource distribution from the center to the states. There were good reasons to question the center's "no-bailout" commitment. Bolstered by the good credit of the federal government, many states had undertaken internal improvements funded by debt. In the face of an unexpected fiscal shock associated with a financial panic, many states refused to introduce new taxes or otherwise adjust. Instead, they demanded bailouts from the central government, joining their (mostly British) creditors in arguing that their debt had implicitly carried a federal guarantee. It is difficult to reconstruct the perceived odds of a federal bailout from historical materials, but it is clear that the debt assumption movement was quite powerful and its failure was certainly not easy to predict. Several states held out bailout hopes to the bitter end and defaulted when the bailout proposal failed in the legislature. Ultimately, they were forced to undertake very painful adjustment measures. But state governments, voters, and creditors learned a valuable lesson: The central government – which was actually prohibited from borrowing on international credit markets during the affair – sent a costly signal of its commitment.

After surviving a few more subsequent tests, the game has been played throughout the twentieth century as if all parties have complete information that the center is committed. That is, the U.S. states approximate fiscal sovereignty. States may occasionally dance around the topic of bailouts – witness the most recent state fiscal crisis – but hopes for bailouts are not sufficiently bright that states would actually refuse to adjust while waiting for debt assumption. When subnational governments are viewed as sovereigns, creditors, voters, and investors face strong incentives to monitor their fiscal activities and threaten to punish unsustainable borrowing, either by raising interest rates, withdrawing votes, or withdrawing capital.

The game has played out differently in recent decades in countries like Brazil and Germany, where several key states have correctly judged the center's commitment as noncredible, refusing to adjust and ultimately receiving bailouts. Clues to the center's lack of credibility were built into the basic intergovernmental agreements that emerged as democracy reemerged in Germany in the 1940s and in Brazil in the 1980s. In both cases, the central government remained highly involved in funding the constituent governments with grants and loans, often with considerable discretion. In Brazil, indebted states knew that they would be able to exert influence in the legislature, and logrolling created a way to bring less indebted states into coalitions to vote for bailouts. Reproducing a pattern that has plagued the federation since the turn of the century, the largest states – especially São Paulo and Minas Gerais – expected that the center could not allow them to default because of negative externalities for the banking system and the country's creditworthiness. In Germany, the constitution provided strong indications that the center would not be able to allow the smallest, most transfer-dependent states to fail. In both cases, the central government has promulgated reforms attempting to reassert no-bailout commitments; but given the lessons learned from the central government's moves in previous plays of the game, state governments clearly continue to make fiscal decisions as if they are playing against a noncommitted central government.

III. Fiscal Institutions

Detailed studies of how this commitment game plays out and evolves in different settings are useful, and several are undertaken in this book. A larger goal, however, is to make some generalizations about the institutional and political characteristics of countries that shape the way the game is played and connect these to distinctive patterns of fiscal behavior. Chapters 3 and 4 argue that the most essential factor shaping fiscal sovereignty is the basic structure of intergovernmental fiscal relations between higher- and lower-level governments. Quite simply, bailout expectations are strongest when subnational governments rely on grants and revenue sharing rather than independent local taxation. Even when the distribution of grants is mostly nondiscretionary, provincial governments can hold out hopes of pressing for increased allocations in future renegotiations. When a highly transfer-dependent government faces default and must close schools and fire stations or fail to deliver health or welfare benefits that are viewed as national entitlements, the eyes of voters and creditors turn quickly to the center for a solution, even if the fiscal crisis was actually precipitated by bad decisions at the local level. If local governments believe that the center's role in financing them will cause the political pain of default to be deflected upward, this not only affects their beliefs about the probability of a bailout, but also reduces their own disutility of default.

Chapter 4 argues that one good way to measure bailout expectations – and hence fiscal sovereignty – is to examine the behavior of credit markets and bond-rating agencies. In the guidelines used by rating agencies to assess subnational governments, transfer dependence is clearly viewed as the best indicator of the central government's implicit guarantee. Bond raters reason that if local governments that are highly dependent upon shared revenues and transfers are allowed to access credit markets, the center understands that it is ultimately responsible and provides an implicit guarantee. Thus, in these cases the credit ratings of the subnationals are tightly clustered around or equal to the sovereign rating, as in Germany. At the other end of the spectrum, rating agencies treat the U.S. states, Canadian provinces, and Swiss cantons – the three federations with the heaviest dependence on independent subnational taxation in the world – as miniature sovereigns; credit ratings (and bond yields) are tightly linked to the independent debt-servicing capacities of the subnational entities. Somewhere in the middle is a country like Australia, where rating agencies clearly pay close attention to the debt-servicing capacities of the individual states; yet taking clues from the intergovernmental transfer system, they explicitly assess a high probability that the Commonwealth government would bail out troubled states in the event of a crisis. This allows transfer-dependent states like Tasmania to pay significantly lower interest rates than they would if they were sovereign borrowers.

Understanding this logic, it is reasonable to expect that central governments with a large role in financing lower-tier governments would tightly regulate their access to credit markets. Indeed, Chapter 4 uses cross-country data to demonstrate a high correlation between transfer dependence and centrally imposed borrowing restrictions. It goes on to show that the combination of transfer dependence and top-down borrowing restrictions is associated with long-term balanced budgets among subnational governments. This is the form of top-down, unitary fiscal discipline that Alexander Hamilton advocated, where the center has a virtual monopoly on both taxation and borrowing and carefully regulates and monitors the expenditures of the subservient lower-level governments. This form of fiscal discipline is in effect in many countries around the world, especially unitary systems in which the local governments have few constitutional protections.

Yet large federations – especially where the provinces were parties to the original constitutional bargain and must sign on to any significant alterations – find it difficult to limit the access of their constituent units to deficit finance. Politically powerful subnational governments with borrowing autonomy and limited tax autonomy can be a dangerous combination. In this context, blurred sovereignty can have troubling macroeconomic consequences. Some countries attain neither the competitive discipline of the modern United States nor the hierarchical discipline of a unitary country like Norway. The center retains much of the power of taxation and the constituent units are highly dependent upon it for finance, yet in various ways the window of local borrowing is left open. As a result, voters and creditors view provincial governments not as sovereigns but as wards of the center, and central governments find it difficult to commit to a policy of saying no to the bailout requests of troubled subnational governments. This undermines competitive discipline and gives state governments incentives to avoid adjustment. At the same time, the political institutions of federalism prevent the central government from exerting hierarchical administrative control over local expenditures. In these countries, federalism poses a dilemma – the central government is too strong fiscally vis-à-vis the states to credibly ignore their fiscal difficulties, yet too weak politically to call them to account.

IV. Political Institutions

Thus, the peril of fiscal federalism is ultimately driven by politics. The first task of the book is to examine fiscal institutions, but the second task – an examination of political institutions – to some extent subsumes the first. The way in which the central government's institutions organize political competition has profound implications for the role of fiscal institutions. First of all, the nature of representation for provincial or local governments shapes the central government's ability to say no when pressed for bailouts by lower-level governments. If the center is merely a loose, logrolling coalition of regional interest groups, it has a hard time resisting bailout requests or firmly regulating the fiscal behavior of local governments. Furthermore, intergovernmental grants and loans from the center to the lower-level