1

Intergovernmental Bargaining and Economic Policy in Federations

Federations across the developing world are in economic trouble. Argentina, Russia, India, Brazil, Nigeria, Pakistan, Mexico, and others are all struggling to varying degrees with profound economic challenges.[1] Only recently, however, have academics, journalists, and the international financial community begun to recognize the distinctly federal roots of some of these problems. In Argentina, which recently experienced one of its worst economic crises of the last one hundred years, chronic provincial overspending and intergovernmental conflicts have been crucial ingredients in that nation's economic freefall.[2] In a less spectacular but equally telling case, the popular press reported throughout 2000 and 2001 that the Indian states were obstructing the federal government's economic reform agenda by reneging on agreements to

[1] The exact definition of federalism is discussed below. Suffice to say that by my criteria, there are ten federal nations in the world of developing and emerging market nations: Argentina, Brazil, Colombia (since 1991), India, Malaysia, Mexico, Nigeria, Pakistan, Russia, and Venezuela.

[2] For examples from the popular press, see *The Wall Street Journal*, "An Argentine Province, Fresh Out of Cash, Pushes an Alternative," August 21, 2001; *La Nación*, "De la Rúa se enojó con los gobernadores," June 7, 2000; *The Economist*, "The Austerity Diet," August 23, 2001; *Novedades Economicas*, "Los desafíos: Reducir gastos, aumentar la eficiencia y reestructurar la deuda," January 1996; *Novedades Economicas*, "El efecto de la crisis financiera en el mercado provincial: Una lección para no olvidar," October 1995. For an academic account of the disfunctionality of Argentina's intergovernmental fiscal system, see Saiegh and Tommasi (1999) or Remmer and Wibbels (2000).

privatize state-owned electricity companies.[3] Similarly, in 1999 intergovernmental conflicts over state debt in Brazil helped trigger the run on that nation's currency, the *real*.[4] More recently, the new Worker's Party government of Lula da Silva faces an awe-inspiring debt burden caused in large part by a decade of federal bailouts of overspending states. Post-Soviet analysts of Russia tell an analogous story of Russia, suggesting that the strength of regional bosses has precluded a coherent national approach to privatization, government restructuring, and fiscal policy.[5]

What is striking about these (and other) federations is how important regional governments are in shaping economic reform processes aimed at giving market mechanisms greater sway. In case after case, conflicts between national and regional leaders stymie or complicate the market reforms that have been at the very heart of developing nation political economies for two decades. Although in some cases national leaders might have strong interests in reforming trade regimes, addressing fiscal imbalances, deregulation, privatization, and so on, subnational politicians often have political incentives that run in just the opposite direction. Consistent with the institutional design of federations, regional decision makers have responded to their own electoral incentives and in doing so have often eschewed the austerity and political uncertainty associated with major economic initiatives. In other cases, national governments resistant to market-friendly initiatives have hamstrung entrepreneurial regional governments. In federal nations, which typically devolve significant fiscal and functional responsibilities to regional leaders, the result is that many policy changes that fall under the market reform umbrella suffer from collective action problems. Thus, in many of the largest and most important emerging

3 See *The Economist*, "Enron, and on, and on: Indian Power and Enron's Indian Troubles," April 21, 2001; *The Economic Times*, "Endgame for Enron," August 19, 2001; *The Hindu*, "Reform in the States," January 24, 2001.

4 See *The New York Times*, "Brazil's Government Pays Foreign Debt Owed by One of Its States," February 11, 1999; *The New York Times*, "Brazil's Economic Crisis Pits President Against Governors," January 25, 1999; *The Economist*, "No Peace for Brazil's President," January 21, 1999.

5 See *Moscow News*, "Regional Budget Spending to be Cut," May 21, 1998; *The Economist*, "The Bridling of Russia's Regions," November 9, 2000; *The Economist*, "Edward Rossel, Russia's Ungovernable Governor," November 5, 1998. Academic accounts include those by Solnick (2000) and Stoner-Weiss (1997).

market and developing nations in the world, economic reforms depend on subnational as well as national economic reform policies and each phase of market liberalization becomes subject to complex intergovernmental bargaining.

Existing academic literatures tell us little about how these federal conflicts influence market reform processes. On one hand, the voluminous literature on the politics of economic reform in developing nations has overwhelmingly focused on national politics. National executives, bureaucracies, legislatures, and interest groups – these, most research tells us, hold the keys to understanding the fate of market reforms.[6] One common theme that emerges from tests of these national-level explanations is the importance of fusing power to initiate and sustain difficult reforms. It is a bit surprising, therefore, that researchers have paid less attention to the geographic dispersal of power, which is the *sin qua non* of federations. As a result, the economic reform literature has failed to appreciate (though with mounting exceptions) the role of decentralized politics for market reform processes. The key comparative factors that exacerbate or ameliorate intergovernmental economic conflicts remain something of a mystery.

On the other hand, the literature on federalism (both fiscal and political), although aware of the potential for intergovernmental conflict, traditionally has focused on a small number of economically successful cases in the OECD cases (and particularly the United States), with little attention to comparative theory building. Given the lack of a comparative lens, it is not surprising that the conventional wisdom emerging from these success stories has been a supposed affinity between federalism and markets. Unfortunately, that conventional wisdom jibes little with the experience of many federations in the developing world. Even the most influential and profound recent exception to the atheoretical tradition in the federalism literature, namely Weingast's (1995) integration of the fiscal federalism and political economy literatures under the moniker of "market-preserving federalism," undertheorizes the crucial factors that determine the degree to which intergovernmental conflict impedes (rather than contributes to) the development of markets. Thus, although analysts working in the market-preserving tradition

[6] For noteworthy works in this vein, see Przeworski (1991), Haggard and Kaufman (1995), and Nelson (1990).

have fastidiously defined some general conditions under which federalism is most likely to produce good economic outcomes, they have not theorized the tremendous diversity in economic outcomes across federations. In this literature, political systems are either market-preserving or they are not, with little attention to either the conditions for a shift toward market-friendly policies or the diversity of economic experiences *across* and *within* federations through time.

These shortcomings bring to mind William Riker's seminal work *Federalism: Origin, Operation, Significance*. Published nearly fifty years ago, he stressed in the Preface both the importance and difficulty of comparative research on political federalism. He wrote that:

> Years ago, when I first thought of writing something like this book, I wanted to make a truly comparative study of federalism, which seemed to me to be exactly the kind of subject about which we might easily utter testable generalizations. . . . In time, however, I came to realize this far too pretentious a project for one man. (1964: xi–xii)

Instead, Riker basically utilized a single case to generate general hypotheses. For decades, Riker's implicit challenge to engage in a theoretically driven comparative inquiry of federalism went all but unheard – a fact that contributes to the poor state of knowledge on the relationship between federalism and everything from economic policy to representation to ethnic conflict in many of the world's federations. In recent years, however, an eclectic blend of comparative political scientists and economists has begun to fill the void, particularly with respect to developing and emerging market federations.[7] If the delay brings to mind the adage "better late than never," the recent explosion of research suggests a widespread desire to make up for lost time. As often is the case in the social sciences, events of the moment (such as historic moves to free markets) have driven the proliferation of studies on federalism.

[7] The comparative federalism literature has expanded exponentially in recent years. Some of that research has focused to varying degrees on the role of federalism in shaping market reforms. See Treisman (1999b, 1999c, 2000), Stepan (2000), Shleifer and Treisman (2000), Blanchard and Shleifer (2000), Solnick (2000), Rodden and Rose-Ackerman (1997), Remmer and Wibbels (2000), Wibbels (2000), Saiegh and Tommasi (1998, 1999); Rao (1997); Huang (1996b), Gibson and Calvo (2000), and Chhibber and Eldersveld (2000).

This research contributes to this rich area of research by developing a comparative theory of intergovernmental conflict designed to account for variations in the degree to which federations are able to make the difficult transition to market-based economies. Although focused on the specifics of market transitions in the developing world, the study also contributes to the more general search for the conditions under which decentralized governance contributes to or obstructs the development of markets. The work's central insight is that the intergovernmental checks and balances deified by theorists from the writers of the *Federalist Papers* to many contemporary social scientists generate institutional obstacles to economic reform policies under fairly common conditions. Although federalism may check the central government's expansive tendencies and foster market-friendly competition among subnational governments under certain circumstances, it need not. Indeed, federalism will only function as traditionally envisioned when both national *and* decentralized governments are attuned to the demands of the market. Such is quite rarely the case in the developing world. In the ideal case, governments can compete without fundamental conflict over the appropriate role of the market in shaping economic relations. Under conditions common in many of the developing world's federations, by contrast, profound disagreements across levels of government over the role of the public sector in the economic sphere create a more insidious version of intergovernmental conflict and serious collective action problems vis-à-vis policy reform. Far from generating efficiencies, such conflict is likely to contribute to policy intransigence, poor economic performance, as well as deep-seated antagonism over the very rules of federalism's intergovernmental game.

The analytical challenge, then, is to understand the key features of federations that shape the degree of intergovernmental conflict over economic policy. In brief, the theory developed here suggests that many market reform policies are a function of a constant process of bargaining between national and regional leaders struggling for political survival. As the degree of national-regional disagreement mounts, collective action on reforms that require implementation at multiple levels of government becomes more difficult. The degree to which the two sets of actors conflict depends on four crucial factors: the electoral interests that each brings to the game, a shared intergovernmental fiscal system, the manner in which regional interests are represented in national policy making, and the levers of partisan influence national leaders have over subnational politicians. Below, I briefly sketch how these factors interact to shape the federal bargaining context.

Consistent with their distinct electoral considerations, each actor in this federal game comes to the bargain with political interests and policy preferences of their own. National governments often come to the intergovernmental bargaining table with incentives to promote national economy stability. In recent decades such stability often requires market reforms, the likes of which international markets demand (Kahler 1986, 1992) and for which voters have often rewarded incumbents in many nations (Stokes 2001a, 2001b). In other cases, however, the distributional consequences of reform are prohibitive in the short term (Przeworski 1991), thus generating national incentives to resist reform. Each regional politician – be they senators, national representatives, or governors – responds to their own electoral incentives generated by a particular subset of the electorate, which may or may not recognize the relationship between regional policy and the fate of broader reforms. Building on arguments developed by Geddes (1994), Remmer (1998), Hellman (1998), Alt, Lassen, and Skilling (2001), De Figueiredo (2002), and others, I suggest that political competition primarily determines those incentives. Where competition is keen, regional electorates and leaders will be more closely attuned to the efficient provision of public goods and the demands of the market. By contrast, where regional politics are uncompetitive and clientelistic (quite common in the developing world's federations), subnational political considerations are likely to militate against economic reforms that would limit public sector patronage and challenge the political survival of incumbents. In short, representatives from competitive regions are more likely to have political incentives consistent with market reforms than their counterparts who lead politically hegemonic regions.

Given these political incentives distinct to each actor at both levels of government, a shared intergovernmental fiscal system provides incentives for both sets of politicians. Although some fiscal systems encourage market-friendly behavior, others promote overspending on the part of regional politicians and post hoc bailouts by national leaders. A long-standing finding in the public finance literature holds that as the share of subnational revenues coming from central transfers rather than their own tax effort increases, governments spend more (Oates 1972; Bird 1986). Because regional voters, politicians, and representatives in the central legislature all receive benefits from grant programs without internalizing their full cost, they demand more expenditures funded by grants than by taxes raised by their own level of government (Weingast, Shepsle, and Johnson 1981; Rodden 2003c). As a result, such transfers encourage regional politicians to compete for resources from the common pool of national revenues, and the fiscal system itself becomes the subject of intense intergovernmental bargaining. The very ground rules of the federal system become the subject of political gamesmanship. One central implication is that regional government resistance to market reforms will mount as their dependence on transfers increases, which will vary both across regions within federations and across federations themselves.

Such fiscal systems also have implications for the behavior of national politicians. Most important in this respect is that in nations where central governments bear the burden of financing regional governments, they often succumb to regional demands for fiscal bailouts (Rodden 2002). As transfers accentuate the importance of intergovernmental bargaining, the national government finds itself the subject of intense lobbying – the end result of which is often politically motivated rescue packages for friends at the regional level. Of course, all such post-hoc bailouts provide incentives for regions to spend extravagantly in the future (Wibbels 2003). Broadly speaking, therefore, the weaker the link between regional taxing and spending, the greater the incentives for both regional and national politicians to engage in the kind of fiscal expansion that can threaten market reforms (von Hagen and Eichengreen 1996; Rodden 2002).

Given their electoral and fiscal incentives, actors at both levels of government have political mechanisms for influencing the other. Regional leaders have leverage through representation (be it formal or otherwise) in the national policy-making process. In federal systems, this traditionally occurs through the Senate, although in nations such as Argentina and Russia, the governors themselves are the crucial bargainers. Given the nature of regional representation, the size of the regional coalition for and against market reforms becomes key to determining their relative influence with national leaders. When antireform regions represent a solid majority in the national legislature, for instance, they are likely to be quite capable of forcing chief executives to put market reforms on the back burner. Alternatively, in cases where regional majorities are market-friendly, they will smooth the path for presidents and prime ministers intent on policy change. This emphasis on the manner in which regional interests are represented at the national level underscores both the leverage regions have over central politicians and the ways in which coalitions of regions can come to check each other.

National leaders themselves are not defenseless in this intergovernmental game. Most important, they have varying capacity to discipline regional leaders through the party system. Fiscal resources and appointment powers allow national politicians to shape the incentives of their regional copartisans. Where national leaders hold a strong partisan position in the regions and head a centralized party, their capacity to foster subnational reform increases. The incentives for reform need not, however, come from the top down. When the electoral success of regional politicians depends in part on the fate of their national compatriots through coattail effects, for instance, they have incentives to contribute to the collective good of economic policy coordination. Although some recent literature has emphasized the importance of strong, national parties to discipline profligate regional governments, I argue that intergovernmental partisan harmony achieved via coattails is a more reliable foundation for extending market reforms to the subnational level. In the former case, subnational reforms reflect central calculations, which may be incompatible over the long term with regional political realities. In the latter case, reforms emerge out of the electoral considerations of regional leaders themselves, resulting in a kind of policy ownership that can help sustain reforms over the long haul.

Together, these factors provide a dynamic account of the intergovernmental politics associated with market reforms that improves on the current literature in several ways. First, the model allows for variance in the degree of intergovernmental economic conflict across federations and within federations through time. Traditionally, most federalism research has been case-study driven and/or focused on categorizing systems as market-preserving or not. The first approach pays insufficient attention to the range of economic outcomes across federations, whereas the second ignores the ebb and tide of market-friendly policies within federations through time. Second, the model also takes distinctly regional politics seriously. Much of the existing research on federalism is focused on relations between central governments and the regions *as a whole*, despite the fact that regions within federations vary significantly in their political interests. In focusing on diverse levels of regional electoral competition and dependence on central fiscal transfers, this model emphasizes not just center-regional relations but also the ways in which regional leaders respond to their own subnational survival considerations and thereby come to bargain with each other over market reform initiatives. Third, the model focuses attention explicitly on intergovernmental *politics* at the expense of formal institutions. Consistent with the current focus on institutions in comparative politics more generally, much recent research emphasizes the centrality of formal fiscal rules and budget constraints in shaping regional economic behavior. I suggest that the arrows of causality run in the opposite direction, from regional and national politics to the structure of intergovernmental institutions. Focusing on the formal rules of the fiscal system at the expense of the bargaining that produced them is likely to lead to excessive emphasis on institutional engineering as a solution for intergovernmental economic problems. Fourth, this model helps move the federalism research away from its common, normative attention to economic efficiency. Rather than prescribing what efficient federations should look like, this model contributes to the development of a positive theory of federalism that can account for how systems actually work. Fifth and finally, although I develop the model of intergovernmental conflict with specific reference to economic policy and test it on a sample of developing nations, it is flexible enough to be transferred to research on other policy spheres and regions of the world. Researchers of the United States, for instance, underscore the role of federalism in shaping twentieth-century debates over civil rights policy. More recently, some have become interested in how competing national and regional demands for representation in the policy-making process are solved in ethnically conflictual federations (Aleman and Treisman 2002; Amoretti and Bermeo 2003), whereas others are concerned with how intergovernmental politics shape policy responses to the mounting income and regional inequality so characteristic of an integrating international economy (Linz and Stepan 2000). The model developed here can shed light on all of these crucial issue-areas from a broadly comparative perspective.

Peeling the Onion: Research Design, the Empirical Approach, and Outline of the Book

Testing the model of intergovernmental bargaining implies a series of distinct comparisons: between federal and unitary systems, among federal systems themselves, and across regions within federations. The research design challenges are exacerbated by the fact that some of the necessary data is not available cross-nationally, whereas refinements of the argument require careful examination of causal mechanisms. As such, the empirical research is carried out in five chapters and integrates statistical and case study analysis, thereby benefiting from the advantages of each (King, Keohane, and Verba 1994). Where cross-sectional time-series data is available, I use the statistical approach. In these chapters, I focus on the developing world because it is those nations that have undergone the most profound recent shifts in economic policy, there where federalism scholars have investigated least coherently, and quite simply because to do more would stretch the author's substantive knowledge of cases to the breaking point. When the argument is too fine-grained (as it is with regards to coattails) and/or the data is not available (as with regional electoral data across federations), I rely on a case study of Argentina's intergovernmental conflicts over market reforms during the last twenty years. A second challenge is that the term "market reform" implies a vast number of policy changes ranging from labor market reform to trade liberalization. Although I discuss the applicability of the model to a range of reforms in the introductory chapter, the empirical focus is on macroeconomic policy. This approach has the advantages of delimiting the scope of research, focusing on a policy sphere traditionally understood as distinctly national, and contributing to a better understanding of one of the most important, initial phases of market reforms. The empirical chapters begin with the most general question (are federal systems macroeconomically different than unitary ones?) and move on to the most specific (why do some regions within nations reform while others do not?). Together, the five chapters present a detailed elaboration and careful test of the model.