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Analyzing Federalism

Stylized Models and the Political Economy Reality

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I. INTRODUCTION

How does federalism affect policymaking? How do the details of the division of policy authority as well as expenditure and revenue powers across levels of government affect prospects for efficient and responsive governance? How does the economic, social, and political context – especially the recent wave of globalization and domestic economic liberalization – affect the workings of any given federal arrangements?

These questions have given rise to a large and varied positive literature on the actual workings of federalism as well as a significant normative literature full of suggestions for how federations should allocate fiscal and other decision-making authority across several levels of government. The literature ranges from stylized models of the costs and benefits of different ways of allocating fiscal authority among social planners in closed economies to detailed research on the nuances of interactions among levels of government in particular countries, time periods, and policy areas.

On one end of the spectrum of research on federalism, national and subnational governments are assumed to act as benevolent social planners who are omniscient and omnipotent, with national planners capable of addressing any externalities from subnational social planners' actions that spill over from one region to another. Social planners at all levels are assumed to have all the relevant information and capacity for enforcement of their decisions. Opportunistic behavior is assumed to be nonexistent. Evaluating fiscal federalism in a closed-economy setting is another common simplification used to keep models tractable and implications for federal design and function clear.

On the other end of the spectrum, political economy analyses incorporate policymakers with diverse abilities and less than public-minded motivations, economic settings that include both international and domestic factors, and other historical and social details. This part of the literature also considers various constraints on the central governments' ability to carry out policies. A smaller subset of the analyses of federalism delves into the dynamics of federalism, analyzing the politics of assigning responsibilities to various levels of government and the factors behind evolving federal structures. The constantly changing de jure and de facto arrangements for central–subnational government interaction present perhaps the most complex challenge for analyzing federalism.

The lessons from across the research spectrum are sometimes conflicting. Policy recommendations that make sense in theory may have demonstrable negative consequences in practice, in part because theory may abstract from consequential aspects of reality. Some federal arrangements we see in countries around the world may make no sense from a public economics perspective. The most stylized models that deliver the broadest implications for assigning taxation and expenditure powers have little explicit advice about how to design federal institutions to withstand bargaining among levels of government, corrupt politicians, and political pressures from interest groups. In-depth country studies, however, offer narrower, context-specific "best practices" and the causal links between federalism and political or economic outcomes may be difficult to verify. Our understanding of how and why federations evolve over time remains limited.

This book jumps into the fray with a collection of case studies of the evolution and interaction of federalism, economic reforms, and globalization in Argentina, Australia, Brazil, Canada, China, India, Mexico, and Nigeria. The countries vary widely in level of economic development and socio-political characteristics, but all share the common challenge of governance with several distinct levels of government.

Each case study focuses on several key questions. First, how have federal institutions evolved over time? What are the forces behind changes in fiscal arrangements, power sharing among levels of government, and political as well as economic institutions? Second, how does the changing economic environment, especially globalization as exemplified by greater openness to international capital and trade flows, affect federalism? What new strains, if any, does globalization place on federal governments and how have the countries we study responded? Third, what kinds of institutional and political arrangements are associated with greater macroeconomic stability and more flexibility to carry out economic reforms? What specific features of the federations we study make these countries vulnerable to shocks, overborrowing, and other well-known dangers of federalism? How does the division of policymaking power across levels of government affect the prospects for economic reforms such as privatization and opening to the international economy? Integration with world capital and goods markets raises new policy challenges such as financial sector reform and regulatory reform for all countries; division of power across levels of governments may affect nations' ability to respond.

The authors use analytical narratives to explore these questions.[1] Much of the analysis of the politics of federalism and the interaction among the institutions, policymakers, and economic environment is based on game-theoretic reasoning, but the presentation is narrative. The various chapters include detailed descriptions of the evolution of federal institutions over the past century, the current economic and political circumstances, and other aspects of the country contexts. The format borrows analytical clarity from formal theory, but without being bound to the same stark stylized representation of federalism.

This introductory chapter provides context for the country case studies by discussing the range of the literature on fiscal federalism from models of "economic federalism" to the more complicated politico-economic analysis of federalism.[2] A concluding chapter highlights the findings that emerge from the country studies.

II. OVERVIEW OF COUNTRIES

The countries studied represent a varied cross section of six developing and two industrialized federal nations (Table 1.1). Incomes per capita varied from over US$25,000 Purchasing Power Parity (PPP) in Australia and Canada to US$758 (PPP) in Nigeria in 2002. The range of levels of development allows us to see federalism interacting with a variety of economic environments. Canada and Australia provide examples of federalism against a context of relatively efficiently functioning democracies and markets, whereas, in other countries, the workings of federal

[1] See Bates et al. (1998) for a methodological overview and examples of analytical narratives.

[2] The term *economic federalism*, as well as the terms *cooperative federalism* and *majority-rule federalism* used in the next sections, is drawn from Inman and Rubinfeld (1997).

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Table 1.1. *Economic Overview*

Country	GDP per Capita (PPP, Constant International $), 2002	Annual Growth (per Capita GDP), 1991–2002	Population (millions), 2002	Trade Openness (% GDP), 2002	Annual % Growth Trade/GDP, 1991–2002	FDI (% GDP), 2002	Annual % Growth FDI/GDP, 1991–2002
Argentina	9,633	1.43	36.48	40.49	10.57	0.77	17.48
Australia	25,032	2.17	19.66	41.76	1.94	4.06	30.12
Brazil	6,878	1.22	174.49	29.41	6.21	3.66	36.10
Canada	26,114	1.60	31.36	82.46[i]	4.38	2.87	22.61
China	4,054	8.77	1280.40	54.77	5.35	3.89	20.15
India	2,365	3.52	1048.64	30.82	5.92	0.59	42.42
Mexico	7,947	1.22	100.82	56.38	4.20	2.29	15.36
Nigeria	758	−0.61	132.79	81.26	1.78	2.94	10.25

[i] This figure is for 2001.

Source: World Development Indicators (2004).

states interact with the challenges of nation-building and economic development.

Brazil and Argentina, two much-studied Latin American federations, were included as examples of countries in which authoritarian regimes have historically alternated with democratic ones. The countries also have a common history of macroeconomic instability, including episodes of hyperinflation and significant subnational overborrowing. Brazil has taken significant steps to limit these vulnerabilities, whereas Argentine economic reforms have stalled with the 2001 crisis. With Mexico's increased integration of its economy with those of the United States and Canada after the adoption of NAFTA over the past decade and the current challenge of second-generation reforms and increasing economic disparities across states, its economic circumstances resemble those of Brazil and Argentina, but the political context of transition from one-party to multiparty rule provides some contrast.

The world's two most-populous nations, China and India, one a thriving multiparty democracy, the other an authoritarian one-party state, are included. Both are actively pursuing economic reform and greater international integration as well as facing the challenge of eradicating poverty. China's federalism is also distinct from others in the study in that most of the decentralization has been in the economic rather than the political realm.

Nigeria, the poorest country in the sample, is resource-rich but has significant economic challenges to overcome in addition to consolidating a relatively new and unstable democracy.

Cross-border flows of goods, services, and capital as well as international migration are increasingly important facets of the economic environment for all countries. Table 1.1 summarizes several indicators of global integration for the countries studied in this book. Trade flows (imports and exports) as a percentage of GDP range from a low of 29% in Brazil to a high of 81% (driven mostly by oil exports) in Nigeria, with others closer to the high end.[3] India's growth in the trade to GDP ratio over the 1990s is the highest, at 5.9% per year, but growth in other countries has not been significantly lower. The large developing countries – Brazil and China – are among the highest recipients of foreign direct investment

[3] It is important to note that these numbers are not necessarily indicators of policy orientation. Whereas India's low level of integration is likely related to its high tariff and nontariff barriers, Nigeria's apparent "openness" reflects the dominance of oil. The trade to GDP numbers may also be misleading: GDP measures value added; trade is gross value. The ratio will thus be inflated for countries that import intermediate goods and then reexport.

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relative to GDP, but higher income Canada is also among the top. Foreign direct investment as a percentage of GDP is growing fast as well, particularly in India.

All of the countries except China have at least one tier of elected subnational governments with a structure that parallels the central government.[4] Most of the elected subnational governments have no formal accountability to the central government. India is an exception, as its states have centrally appointed governors alongside their elected legislatures and executive chief ministers. The state governors are nominally appointed by the president, but that are effectively agents of the more powerful central government and its head, the prime minister.[5] Although the legislatures are elected by the citizens and propose governments of their choosing that are accountable to the legislatures, the central government is constitutionally empowered (Article 356) to suspend elected state governments or temporarily replace them by central rule.[6]

Nigeria's transition to democracy is the most recent. The 1999 Constitution provides for an executive, judicial, and bicameral legislative branch at the national level and state level, the third-tier local government areas have an elected chairman and council of leaders.

China's structure stands out among the countries in this study as being economically decentralized but politically centralized. It is clearly not a federal country in the political sense. The cession of control over local economies and reduction of controls on local government-owned enterprises has in some ways substituted for political decentralization to elected subnational leaders. The arrangement is generally regarded as economically beneficial in that provinces' economic powers offset the threat of central government expropriation and provide a stable environment for investment, but its political effects are unclear.[7]

The political units at the first tier of subnational governments, however, are still quite large in several countries we study. The smallest Indian state has a population of 60,000 and many are in the tens of millions. The

[4] With the exception of a few elected leaders at the fourth (township) tier of government or below, subnational leaders are appointed by the levels above them.

[5] The Indian president and state governors are not quite the analogues of constitutional heads of state, nor are they heads of government. The Constitution endows them with the power to force candidates for prime ministership (or chief ministership at the state level) to prove that they have support of a majority of members of the Parliament or state legislature. Indian state governments have an unusual dual accountability.

[6] This power was used relatively frequently in the past, but it has been exercised less recently.

[7] China is the model for Weingast's (1995) account of "market preserving federalism."

largest, the state of Uttar Pradesh, has a population of over 166 million. Argentina's provinces range from 115,000 to over 14 million people.

Smaller political units have varying degrees of independence. Canada, Australia, and India have lower tiers of governments that are under the states/provinces' control. Elected local governments (called districts, *taluqs*, and *panchayats* in order from largest to smallest substate jurisdictions) are under the Indian state governments' control and state-level finance commissions determine how to allocate funds to lower levels of government. The constitutional status of India's panchayats was recently clarified, giving them a greater role in decision making while reiterating that they are under state governments' control, in 1993. Canada and Australia's municipalities are also subject to provincial control but have no constitutional status. China's five tiers of government are similarly hierarchical. Each level of government determines tax-sharing agreements, grant distributions, and expenditure responsibilities for the level immediately below. The first tier governments delegate local functions such as waste disposal and maintenance of local infrastructure to these levels of government.

The Nigerian and Brazilian local governments are more directly connected to the central government. The Nigerian National Assembly prescribes the states' allocation of transfers to this third tier and the Brazilian central government transfers resources directly to the municipal governments. This third tier of government is constitutionally recognized and largely independent of the second tier.

Ethno-linguistic and socioeconomic heterogeneity varies across countries as well, from the ethnically divided Nigerian states and multilingual, multicultural India to the relatively more ethnically homogeneous, but economically diverse China. This diversity within nations has had varying effects on the federal states: interstate and center-state politics are heavily influenced by ethno-linguistic differences in Canada and Nigeria, but economic differences appear to dominate in relationships among states in socioeconomically heterogeneous Brazil. Competition for shares in national revenues and negotiation over the terms and extent of redistribution comprise a major part of politics in all of the countries.

The more ethnically diverse states have shown some tendency to subdivide over time, producing smaller, more ethnically homogenous units, but this is not a widespread phenomenon. Indian states were formed after independence so that the language spoken by a majority of its population would be the same. There have been a few new states created since then; most recently three new states were created in the late 1990s.

However, violent separatist movements, notably in Kashmir and also in the northeast, continue to be active. The Nigerian federation has changed the most: There were originally three regions in 1946 and there are thirty-six currently.

III. ECONOMIC FEDERALISM

Inman and Rubinfeld (1997) summarize economic federalism as

> preferring the most decentralized structure of government capable of internalizing all economic externalities, subject to the constitutional constraint that the central government policies be decided by an elected or appointed 'central planner'. (p. 45)

The analyses of federalism in this subsection of the literature abstract away from policymakers' career objectives, possible corruption, and ideologies as well as the question of how the federal system interacts with the economic and social environment around it. The advantage of such an approach is that it produces straightforward, general conclusions and policy prescriptions. The ideas discussed in this section continue to shape the international policy community's views on the benefits of greater decentralization.

The economic federalism literature proposes several advantages of dividing taxation and expenditure authority across levels of government. Local governments are assumed to have an information advantage in identifying local needs. Decentralization also allows for more variety in the provision of public goods so that local preferences can be satisfied.[8] Mobility ensures efficient matching of citizens with jurisdictions that provide the public goods they prefer.[9] Local governments are also potential laboratories for policy experiments.

Economies of scale, agglomeration, and externalities could offset these benefits of decentralization to varying extents. Some public goods may have economies of scale that cannot be obtained in smaller subnational jurisdictions. Agglomeration economies favor concentration of economic activities in metropolitan cities, so that tax bases might be concentrated in one jurisdiction while revenues for services are needed in another area, perhaps where some of those who work in the city live. Local policies can have spillovers for other jurisdictions – environmental regulations in one town can affect pollution in another town, for example.

[8] Oates (1972, 1994).
[9] Tiebout (1956), Bewley (1981).

The same mobility that ensures matching of citizens with jurisdictions also limits the potential for redistribution by subnational policies. Progressive taxation and generous welfare benefits are likely to drive the well-off away and attract the poor, eroding the scope for redistribution.[10] The most stylized analyses thus generally recommend that the central government carry out most redistributive policies.[11] As the country case studies will show, this kind of centralized redistribution may no longer be as ideal when central governments redistribute to ensure longer tenure in office or other non-welfare-related goals.

Gordon's (1983) derivation of optimal tax rates for a federation provides another example of the kinds of policy recommendations that this subsection of the literature offers. The paper works out the central and subnational taxes a benevolent social planner would set, solving six equations that balance a variety of welfare goals.

The solutions to these complex calculations are unlikely, however, to be the taxes that any kind of politicians would choose.[12] The approach ignores policymakers' potentially opportunistic motivations as well as strategic interactions among levels of government. The general policy prescription is to have as much central control over tax rates and bases as possible, since subnational governments will overlook the many externalities that their taxation decisions create.[13] Competition for businesses and citizens may lead subnational governments to set inefficiently lower business and income taxes, for example. Subnational governments' efforts to exclude socially beneficial but locally unpopular activities (such as dumps or nuclear-waste processing) can lead to excessive taxation in other cases. Lower level governments' quest to tax less mobile bases is also likely to lead to regressive taxation since the poor tend to be among the least mobile.[14]

These clear prescriptions, however, are based on strong and possibly unrealistic assumptions. The assumption that central and local governments are able and benevolent social planners who do not interact strategically with each other, though unrealistic, plays a crucial role in the

[10] Gramlich (1985).
[11] Central control over redistribution is complicated, however, by the difficulty of separating redistribution from provision of public services. See Musgrave (1997) for a discussion of the implications of ongoing devolution for redistribution.
[12] Inman and Rubinfeld (1996).
[13] Only the special case of a Tiebout (1956) economy – in which states compete for residents and uses a residential head tax to pay for public goods – achieves efficiency within a decentralized tax setting.
[14] Oates and Schwab (1986), Inman and Rubinfeld (1997), Wildasin (1989).

cost–benefit analysis for decentralization, for example. The economic federalism framework also focuses on closed economies, in contrast to the reality of international integration.

Economic federalism analyses also offer few insights into how federal structures are chosen and change over time. The literature provides principles for allocating rights to taxation and expenditure responsibilities, but it does not examine whether these are associated with a unique and stable political equilibrium. Tiebout's (1956) assertion that people will "vote with their feet" to sort themselves into separate jurisdictions with responsive subnational leaders is one of the few theories in the conventional analysis that proposes a mechanism (albeit one whose convergence to a unique and stable equilibrium is not assured without additional assumptions) for how federalism moves toward distributing resources efficiently. Nevertheless, it is only a theory of an equilibrium in which people and subnational governments are optimally matched and does not speak to the constant revisions to the federal bargain between the states and central government.

IV. POLITICAL FEDERALISM

Political federalism adds an additional layer of complication by dropping the assumption that central governments are omniscient social planners. Policymakers are primarily politicians in this framework, motivated by prospects of reelection, the "perks" of office (which could include private returns from its corrupt use), lobbyist contributions, and other factors in addition to (or instead of) general social welfare. Administrators at all levels may or may not have the capacity and power to enforce the policies they deem desirable. Policymakers may or may not have complete information for determining which policies are desirable.

The literature on political federalism also assumes that levels of government interact strategically, so that the central government is no longer autonomously able to alter subnational policies. Central governments must bargain with subnational governments to gain support from all or at least some minimum fraction of them. The change in assumptions has significant consequences for the optimal federal institutions and has additional explanatory power for the outcomes we observe in decentralized countries.

The increasing prevalence of political considerations in the analysis of federalism over the past decades was inspired in part by the growing public choice literature as well as the reality that the assumptions underlying