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0521603668 - Hamilton's Paradox: The Promise and Peril of Fiscal Federalism

Jonathan A. Rodden

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## *Hamilton's Paradox*

As new federations take shape and old ones are revived around the world, a difficult challenge is to create incentives for fiscal discipline. A key question is whether a politically motivated central government can credibly commit not to bail out subnational governments in times of crisis if it funds most of their expenditures. The center can commit when subnational governments retain significant tax autonomy, as in the United States. Or if the center dominates taxation, it can tightly regulate borrowing, as in many unitary systems. In a third group of countries, including Brazil and Germany, the center can neither commit to a system of market-based discipline nor gain a monopoly over borrowing. By combining theory, quantitative analysis, and historical and contemporary case studies, this book explains why different countries have had dramatically different experiences with subnational fiscal discipline. Moreover, it provides a new perspective on a tension between the promise and peril of federalism that has characterized the literature since *The Federalist Papers*.

Jonathan A. Rodden is the Ford Career Development Associate Professor of Political Science at MIT. He was recently a visiting scholar at the Center for Basic Research in the Social Sciences at Harvard University. He received his Ph.D. in political science from Yale University and his B.A. from the University of Michigan, and he was a Fulbright Fellow at the University of Leipzig. In collaboration with the World Bank, he recently coedited a book titled *Fiscal Decentralization and the Challenge of Hard Budget Constraints* (2003). His articles have appeared in such journals as *The American Journal of Political Science*, *The British Journal of Political Science*, *Comparative Politics*, *International Organization*, *The Virginia Law Review*, and *World Politics*.

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THE PROMISE AND PERIL OF  
FISCAL FEDERALISM

**JONATHAN A. RODDEN**

*Massachusetts Institute of Technology*



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Jonathan A. Rodden

Frontmatter

[More information](#)

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*For Ammie*

Contents

<i>Preface</i>	<i>page</i> xi
<i>Acknowledgments</i>	xv
1 INTRODUCTION AND OVERVIEW	1
2 PROMISE AND PERIL: INTELLECTUAL HISTORY	15
3 SOVEREIGNTY AND COMMITMENT	48
4 THE POWER OF THE PURSE: INTERGOVERNMENTAL GRANTS AND FISCAL DISCIPLINE	75
5 DISEASE OR CURE? POLITICAL PARTIES AND FISCAL DISCIPLINE	119
6 AN APPROACH TO COMPARATIVE CASE STUDIES	140
7 FISCAL FEDERALISM AND BAILOUTS IN POSTWAR GERMANY	153
8 THE CRISIS OF FISCAL FEDERALISM IN BRAZIL	188
9 THE CHALLENGE OF REFORM IN FEDERATIONS	226
10 THE ORIGINS OF SUBNATIONAL SOVEREIGNTY	250
11 CONCLUSIONS	269
<i>References</i>	283
<i>Index</i>	301

Cambridge University Press

0521603668 - Hamilton's Paradox: The Promise and Peril of Fiscal Federalism

Jonathan A. Rodden

Frontmatter

[More information](#)

## *Preface*

This project started in the late 1990s with the simple observation that however compelling and elegant, leading theories of federalism in economics and political science had little to do with most of what was interesting about developments in federations around the world. Optimistic theories promised that decentralization would yield improved efficiency and governance in a wide variety of countries. Yet disastrous debt accumulation among state and provincial governments in Argentina and Brazil had direct negative implications for macroeconomic and political stability, and the literature seemed to provide no hint of an explanation. Moreover, similar problems have existed on a smaller scale for some time in several countries and are sprouting up along with transitions to democracy and fiscal decentralization in others. Next, I learned that episodes of unsustainable borrowing by states and provinces, followed by rancorous debates about federal bailouts, are as old as federalism itself. I set out to rethink theories of federalism and fiscal decentralization, develop some testable arguments about the causes of fiscal indiscipline in multitiered systems of government, and confront them with data from around the world.

Much of the book was written before I realized that Alexander Hamilton had already done something like this. Upon rereading *The Federalist* and then moving on to explore his other writings, I gained an appreciation not only of Hamilton's imprint on the United States, but also his imprint on theories and analyses of federalism. Hamilton and his collaborators drew upon theories of Greek and French philosophers and lessons from previous experience, painting a rich picture of the promise and peril of federalism in the late eighteenth century. But the picture is difficult to interpret today.

Cambridge University Press

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Jonathan A. Rodden

Frontmatter

[More information](#)

## Preface

Hamilton's ambiguous intellectual and political legacies create a paradox that frames this book.

In fact, the legacy of Alexander Hamilton is rife with ambiguity and paradox from beginning to end. One of the most vociferous American patriots was born in the West Indies, and though an active campaigner against dueling, his participation in the duel that killed him was supposedly meant as a protest. But his gun was loaded, and it is ambiguous whether he shot at Burr or the discharge of his weapon was an involuntary reflex.

An even more controversial legend of his participation in the duel is that it was a form of suicide brought on by his failure and that of the Federalists to build a powerful central government. While this may be far-fetched, there can be little doubt that Hamilton viewed American federalism at the beginning of the nineteenth century as a complete failure. In fact, Hamilton probably would have viewed anything short of a unitary system as a failure. At the Constitutional Convention, Hamilton is said to have argued that the states should be mere "corporations," at best, and that even in that capacity they would pose a danger to the stability of the general government. Hamilton simply did not believe in the wisdom of dividing sovereignty between central and state governments, and most of his writings and actions served the purpose of building "such a compleat sovereignty in the general Government as will turn all the strong principles and passions" to its side (Miller 1959: 230). As secretary of the treasury, he worked tirelessly to wrest away from the states the power to borrow and tax.

He believed that the Constitution negotiated in Philadelphia was deeply flawed, though much better than the status quo under the Articles of Confederation. According to Joseph Ellis, "Hamilton saw his role in the Federalist Papers as that of a lawyer obliged to mount his most brilliant defense on behalf of a dubious client" (2002: 80). According to John Miller, "[W]hile he was justifying the federalist system he was dreaming of the centralized system that he hoped would emerge from the chrysalis of federalism" (1959: 195). The irony is that the "improvised and disingenuous" (Ellis 2002) legacy of *The Federalist* is an eloquent defense of federalism that has stood the test of time and served as the starting point for generations of theory and analysis that celebrate the virtues of divided sovereignty. It is not difficult to find the influence of *The Federalist* in most theories of federalism and decentralization penned by economists and political scientists ever since. The vast majority of these celebrate the benefits of fiscal and political decentralization.



Cambridge University Press

0521603668 - Hamilton's Paradox: The Promise and Peril of Fiscal Federalism

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Frontmatter

[More information](#)**Preface**

This book pays special attention to the argument that decentralized federalism can enhance the fiscal discipline of government. Hamilton's true convictions about fiscal federalism have largely been ignored by contemporary students of federalism. Yet this book shows that some of his trepidations about decentralized spending and borrowing in the context of federalism were very well founded.

This book returns to the issue of divided fiscal sovereignty with more than two hundred years of hindsight. In seeking to understand the success or failure of decentralized countries to maintain fiscal discipline, it revisits the tension between Hamilton's frustrated political legacy and his celebrated intellectual legacy. It asks whether the disdain for dual fiscal sovereignty that he demonstrated as secretary of the treasury was justified or he was on firmer ground when making his rather disingenuous remarks in *The Federalist* about the intrinsic value of dual taxation, states' rights, and mutual forbearance.

The book argues that both views contained grains of truth. The limits that federalism places on the sovereignty of the federal government can under some conditions sow the seeds of fiscal disaster. But under other conditions, these limitations bolster a rather strict form of fiscal discipline. In short, all federations are not created equal. This book highlights the diversity of federal structures around the world and connects these to widely divergent fiscal experiences. It explains how some countries get stuck in a dangerous equilibrium: The central government – because of its role in funding most provincial-level expenditures – cannot credibly commit to ignore the fiscal woes of troubled provincial governments; but because of its political composition, it also cannot cut off their access to borrowing. In these situations, semisovereign provincial governments can borrow with implicit federal guarantees and overfish the common pool of national revenue, ultimately undermining the creditworthiness of the entire public sector. Other federations have arrived at stable equilibria, where the provincial governments finance themselves primarily through general-purpose taxation, and it is common knowledge to creditors and voters that provinces are responsible for their own debts.

Most of those who build on the optimistic part of Hamilton's rhetoric in *The Federalist* implicitly assume that countries will obtain the latter type of equilibrium. Yet I will argue that this type of federalism is actually quite rare, and in most countries today it would be very difficult to build. Though in retrospect the U.S. experience with divided fiscal sovereignty since the

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Frontmatter

[More information](#)

---

## Preface

Civil War seems to bolster Hamilton's disingenuous legacy, policymakers in most decentralizing countries have much to learn from Hamilton's original skepticism about dual sovereignty. The final chapter will parlay this observation into some potentially controversial policy implications for developing countries and the European Union.

Cambridge University Press

0521603668 - Hamilton's Paradox: The Promise and Peril of Fiscal Federalism

Jonathan A. Rodden

Frontmatter

[More information](#)

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Cambridge University Press

0521603668 - Hamilton's Paradox: The Promise and Peril of Fiscal Federalism

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Frontmatter

[More information](#)

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