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A Political Approach to the Assignment of Powers in a Federal System

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Why do federal Systems differ enormously in their performance? Some are among the richest nations in the world, while others are mired in poverty. To understand the comparative theory of federal performance, I develop a set of conditions that help differentiate among federal systems. These conditions serve a second purpose: the theory of fiscal federalism provides a set of systematic insights into the performance of federal systems. What follows can also be thought of as an attempt to make explicit some of the political assumptions underlying this theory.

All federal systems decentralize political authority, so a clear necessary condition for federalism is:

(H1) Hierarchy. There exist a *hierarchy* of governments with a *delineated scope of authority*.

Yet federal systems differ enormously in how they allocate power. The following conditions characterize how federal states allocate power among national and subnational governments.

(H2) Subnational autonomy. Do the subnational governments have primary *authority over the local economy*?

(H3) Common market. Does the national government have the authority to police the *common market*?

(H4) Hard Budget constraints. Do all governments, especially subnational ones, face *hard budget constraints*?

(H5) Institutionalized authority. Is the allocation of political authority *institutionalized*?

Different federal systems can be characterized by which conditions they satisfy, ranging from the hierarchy condition alone to this condition plus and some of the others to all five conditions.¹

I first consider an ideal type of federalism that satisfies all five conditions called *market-preserving federalism*, (see Montinola, Qian and Weingast 1995 and Weingast 1995). In combination these conditions help foster and preserve markets. The subnational autonomy, common market, hard budget constraint and institutionalized authority conditions limit national power to the task of policing subgovernmental encroachment on the common market and to providing national public goods, such as defense and a stable macroeconomic regime.

Economists have long argued that federalism places state or regional governments in competition with one another. This gives them the incentive to foster local economic prosperity rather than costly market intervention, service to interest groups, and corruption. Of course, a prerequisite for this competition to work is that state governments have the authority to adjust policies to their circumstances – hence, H2, the subnational autonomy condition. In particular, these governments

¹To make this discussion manageable, I will ignore many subtleties and simply assume that each condition either holds or not. For further details, see Montinola, Qian, and Weingast (1995) and Weingast (1995).

must have considerable power to regulate markets.

Economists also emphasize that an important aspect of federalism is that state governments must compete for the “factors of production,” that is, capital and labor. This competition limits the abuse of this authority. The reason is that governments that fail to foster markets risk losing capital and labor – and hence valuable tax revenue – to other areas.

Of course, a prerequisite for this competition to be beneficial is the absence of trade restrictions among the regions – hence H3 the common market condition. The common market condition requires that the states of the federation all participate in one market without internal trade barriers. This has held for the United States since the inception of the Constitution, though it proved a major problem under the previous Articles of Confederation. Similarly, there are considerable restrictions in Russia today on the movement of labor, capital and goods across regional borders. When the common market condition fails, subnational government becomes a *de facto* “national government” within its jurisdiction. This power short-circuits federalism’s limits on subnational governments because it reduces the penalty for costly market intervention.

The hard budget constraint concerns fiscal transfers among levels of governments and government borrowing (see McKinnon 1996 and Wildasin 1997). Under this condition, the federal government cannot bail out states that go into deficit due to fiscal imprudence. A hard budget constraint also prevents states from endlessly bailing out failing enterprises. A hard budget constraint does not limit fiscal transfers to poorer regions, however; but it does constrain how and under what circumstances fiscal transfers are made.

In contrast, states with a soft budget constraint can pursue costly market intervention, service to interest groups, endlessly subsidizing ailing enterprises, or engage in corruption. The reason is that they do not bear the financial consequences of their decisions. The expectation of a bailout lowers the financial costs to the state government (though not to the country) of these expenditures. Argentina in the 1980s and Brazil in the 1990s both experienced hyperinflation as their state governments spent without limits, forcing the federal government to bail them out.

The final condition – institutionalized authority – provides the glue for the federal system. This condition requires that, beyond simple decentralization, the federal structure must not be under the discretionary control of the national government. The absence of this condition allows the national government to compromise subnational government autonomy and hence the benefits from competition among them. The Mexican president, for example, has historically had the power to remove governors (President Salina removed over half the governors during his six year term a few years ago). Similarly, the national government in India has the power to take over states, and has done so on average about once a year since independence. Powers of this sort dramatically reduce the independence of the states because the federal government can threaten those states that do not conform to the federal government’s policy wishes.

A critical feature of market-preserving federalism is that it limits the exercise of arbitrary authority by all levels of government. Federalism limits the central government directly by placing particular realms of public policy beyond that government’s reach. For state governments, constraints are imposed in two ways. First, the central government polices state

abuses of the hierarchy, such as state attempts to impose trade restrictions to products from other states. Second, the induced competition among states places self-enforcing limits on these governments' ability to act arbitrarily (Tiebout 1956, Rubinfeld 1987). As noted, those states that fail to provide a hospitable economic climate lose resources and tax revenue to other states.

No government has a monopoly of regulatory authority over the entire economy, so no government can create monopolies, massive state owned enterprises, solely to provide jobs or patronage, and other forms of inefficient economic intervention that plague developing countries (as Buchanan and Brennan 1980, ch **, have observed). A subnational government that seeks to create monopolies or a favored position for an interest group places firms in its jurisdiction at a disadvantage relative to competing firms from less restrictive jurisdictions.

Third, the hard budget constraint also implies that local governments can go bankrupt. This provides subnational governments with the incentives for proper fiscal management. Local enterprises, politicians, and citizens hardly want their government to spend more money than is prudent. Bankruptcy would greatly hinder the ability of local governments to finance necessary public goods, such as those needed to attract foreign capital and lower business costs.

The following table summarizes the effects of the conditions on federal performance. Federal states that have met all or nearly all five conditions — that is, those characterized by market-preserving federalism — have experienced sustained long-term growth. Federal states failing to meet these conditions have experienced meager or no growth. Throughout its history, the United States has been a market-preserving federal system. Except for a brief period under the Articles of Confederation, the common market condition has always held, as had the hard budget constraints for lower governments (the national government does not bailout states).

Table: Types of Federalism and Economic Performance.		
	Sustained Growth	Meager or Inconsistent Growth
Market-Preserving Federalism	Dutch Republic, 16-17 c Great Britain during the industrial revolution US, 1787 - present Modern China	
Other Federal Systems		Modern Russia Post-WWII: Argentina Brazil India Mexico

England during the 18th century industrial revolution had a market-preserving federal structure, though not a de jure one. Constitutional changes following the Glorious Revolution of 1689 limited the national government's role in the economy and improved local government autonomy. This proved especially important during the industrial revolution, which took place

not in the established commercial centers but in more remote northern England (Weingast 1995). The new entrepreneurs moved to local jurisdictions more hospitable to their economic needs.

Many de jure federal systems differ considerably from the ideal federal system. For example, in Argentina and Mexico, subnational autonomy and institutionalized authority fail, and often the hard budget constraint condition. In most Latin American federalism's, the lion's share of state revenue comes from the national government. This creates several problems. First, it breaks the link between local economic prosperity and fiscal health. Second and perhaps more importantly, along with that much revenue comes restrictions, rules, and regulations of the center. In addition, soft budget constraints in Argentina in the 1980s and Brazil in the 1990s resulted in hyper-inflation due in part to profligate behavior of the lower governments, which forced the federal government to bail them out. Until recently in Mexico, the dominant Revolutionary Party (PRI) used its political power to limit lower government autonomy. The President, as head of the PRI, used his authority to fire governors, thus limiting their ability to act independently (compromising institutionalized autonomy). These Latin American federal systems all compromise lower government autonomy so that these governments have neither the incentive nor the ability to differentiate themselves from their neighbors. More broadly, the failure of subnational autonomy implies that the political discretion and authority retained by the central government greatly compromise their market-preserving qualities.

The de jure federalism of the former Soviet Union provides another contrast between market-preserving federalism and other forms of decentralization. In that system all conditions failed. The Soviet Union was characterized by the nearly complete absence of subnational government policy discretion. Lower governments were administrative units of the central government having little power over their local economies. The center also carefully controlled factor mobility. As a consequence, federalism provided no positive incentives toward economic growth.

Finally, consider modern China. Although it does not call itself federal, China in the reform era has extensively decentralized political decision-making, particularly over lower government budgets and over the economy. China now satisfies all the conditions the common market condition (though there was a modest problem with soft-budget constraints leading to modest inflation in the 1980s). The failure of the common market condition implied that many interior provinces have created trade barriers and "dukedom economies." Because many of the coastal provinces seek to earn rents on the competitive international market, the lack of a domestic common market did not compromise their incentives to foster economic growth. These provinces' political autonomy over economic regulation has allowed them to provide a remarkably hospitable environment for markets and hence sustained economic growth (Montinola, Qian, and Weingast 1995). Indeed, Guangdong's famous "one step ahead" allowed it to use its new political discretion over the economy to attract an unprecedented level of investment and economic growth.

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