Second Generation Fiscal Federalism: Political Aspects of Decentralization and Economic Development

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Summary. — This essay contributes to second generation fiscal federalism (SGFF), which traces the implications of incentives created by political and fiscal institutions. The approach explores how various forms of fiscal federalism work in the presence of political officials who, rather than being benevolent social planners, face various forms of political incentives. The paper focuses on three sets of positive models: First, it explores self-enforcing federalism; that is, how federal systems are held together given various tendencies for federal systems to become centralized or fall apart. Second, it considers how specific political institutions, such as democracy, interact with decentralization. Finally, it studies various political impediments to economic growth, again highlighting the interaction with decentralization.

Key words — intergovernmental relations, federalism, secession, structure, scope and performance of government, publicly provided goods, political economy

1. INTRODUCTION

Traditional approaches to fiscal federalism typically make a series of implicit political assumptions that limit its applicability as a positive model. For this reason, the literature distinguishes between two approaches to fiscal federalism. First generation fiscal federalism (FGFF) studies the performance of decentralized systems under the assumption of benevolent social planners. Second generation fiscal federalism (SGFF) builds on FGFF but also studies the fiscal and political incentives facing subnational officials. The FGFF assumption of benevolent maximizers of social welfare ignores the actual goals of political officials who typically must run for election. This perspective also ignores the problem of how federal systems remain stable given the incentives of officials at the different levels to cheat on the rules; for example, by encroaching on power and prerogatives of another level. Students of SGFF related topics about how decentralization interacts with political institutions, such as democracy, interacts with federal institutions.

This paper adopts a SGFF perspective to address a subset of issues in the political economy of federalism, focusing on four related topics about how decentralization interacts with political institutions and incentives. As this literature remains in the early stages, scholarship focuses on different pieces of the larger whole and does not, as yet, provide a general theory. My purpose is to pull together a few related themes in growing range of SGFF approaches to decentralization.

The first topic addresses the question, how does federalism become self-enforcing? This question explores the institutions and forces that provide incentives for political officials to honor the rules of federalism. As Riker (1964) observed, two problems pose challenges for federal stability, the centrifugal forces whereby the center captures the powers of the lower jurisdictions; and fissiparous forces whereby free-riding and common pool problems facing lower jurisdictions cause the federal system to fail. For example, many nominally federal countries have become highly centralized with respect to real power— including Mexico under the PRI (the Institutional Revolutionary Party that dominated Mexico from roughly 1930 through the mid-1990s; see Diaz-Cayeros, 2006) and India under the Congress party (1950 through the late 1980s; see Roa & Singh, 2005). To remain stable, federal systems with significant policy decentralization must counteract both these forces.

Second, a related issue concerns the assignment problem. How are various policies in a federal system assigned to different levels of government in practice? FGFF has a well-developed normative theory of assignment. What explains why different federal systems assign policies in different ways? Models in the literature tend to reveal various political impediments to the efficient assignment and production of public goods. Unfortunately, students of fiscal federalism have only begun to point toward answers to these important questions.

Third, I discuss several problems involving how democracy interacts with decentralization. After observing that elections and democracy do not provide magic solutions to problems of development, I raise the issue of sequential decentralization rather than decentralization through one great leap. I next raise the problem of “tragic brilliance,” a pernicious use of decentralization by which political officials use elections in the context of decentralization to manipulate citizen behavior rather than the other way around. In many developing countries, local public goods are not administered to all citizens who can pay their bills or taxes, but instead are discretionary on the part of a highly centralized regime (Diaz-Cayeros, Magalon, & Weingast, 2006). Specifically, the regime uses this discretion to convert democratic elections from a system of citizen choice to one controlling citizen electoral behavior. The regime does so by rewarding those districts that support it (with financing for local public goods) while punishing those which fail to support it (substantially less financing for local public goods). Because local public goods are highly valued, the threat of withdrawal if they vote for the opposition forces many citizens to support the regime.

Fourth, I raise political impediments to development and how decentralization can mitigate them. An important

*This paper draws on the author’s larger project on second generation fiscal federalism, especially (Weingast, 2009). The author thanks Jean-Paul Faguet for helpful conversations.
problem in development involves creating perpetuity, the idea
that organizations and institutions are stable beyond the lives
of those who create them. For example, business partnerships
are finite lived (they must be dissolved or reconstituted when a
partner dies); while corporations are perpetual (shares are typi-
cally inherited or sold when a shareholder dies). Most devel-
oping countries have limited or no perpetual institutions, so
new leaders often alter institutions and policies to suit their
purposes. An extreme version of this problem involves the
predatory state, one whose leaders opportunistically change
policies and institutions to extract rents from citizens. I sug-
gest how decentralization can mitigate these problems under
some circumstances. This discussion considers some normative
aspects of the positive, SGFF ideas, drawing several implica-
tions for the design of decentralization. This discussion in-
cludes the idea of initiating federalism “one step ahead”—
decentralization which first allows one region (such as that
most likely to succeed in decentralization) to experiment with
decentralization.

This paper reveals two general themes that arise from the
various topics. One theme is that a wide range of incentives fa-
vor inefficient policy choice, especially the inefficient assign-
ment and production of public goods. The other theme is
centralization. The paper reveals several independent motives
for political officials in the central government to centralize
power, authority, and fiscal resources.

This paper proceeds as follows. Section 2 raises the issue
of self-enforcing federalism. Section 3 discusses SGFF ap-
proaches to the assignment problem. Section 4 turns to prob-
lems of democracy, while Section 5 discusses how decentralization can mitigate the impediments to democracy
posed by a predatory state and by the lack of perpetuity.
My conclusions follow, including the theme of centralization.

2. SELF-ENFORCING FEDERALISM

How do federal states hold together? Riker (1964) and, more
recently, Rodden (2006) and Stepian (2004), emphasize the two
problems of federal stability. In some federal systems, the na-
tional government overpowers the subnational governments,
producing a centralized state. Others face intractable problems
of free-riding by the subnational governments and dissolve
into separate states. A federal system is self-enforcing when
political officials at all levels of the hierarchy have incentives
to honor the rules, including one another’s powers and author-
ity. Self-enforcing federalism, therefore, requires incentives
and mechanisms that mitigate or solve the two problems of
federal stability.

No widely accepted theory of self-enforcing federalism ex-
ists. A large literature suggests that certain institutional fea-
tures of democracy are more likely to preserve decentralization. 2 The literature associates a range of institu-
tions with stable decentralization; for example, when subna-
tional officials are elected, in contrast to serving at the
pleasure of the national government; or when the constitution
designates that the subnational units have direct representa-
tion in the government (e.g., in a “senate”).

In this section, I summarize four theoretical ideas that con-
tribute to self-enforcing federalism. The first considers the role
of political parties in maintaining the federation. A host of
writers follow Riker (1964) and argue that the form of the
party system is essential to maintaining federalism. 3 Some
party systems allow national elites to dominate the parties;
others allow local elites to dominate; and still others afford a
balance of power among national and local elites. When na-
tional elites dominate parties, they are likely to force local
leaders to accept (or acquiesce to) institutional changes that
promise local government powers (as in Mexico under the
PRI, India under the Congress Party, or Russia under
Putin). In contrast, a party system dominated by local elites is
more likely to force national elites to accept subnational gov-
ernment common pool abuses, such as bailing out subnational
deficits (as in Brazil in the late 1990s). Finally, a party system
balanced between national and local elites is more likely to
support decentralization, as both local and national elites
guard their own prerogatives (as in the US). This perspective
begs the issue of what creates different types of party systems
(though see Filippov et al., 2003, who argue that the electoral
system generates the party system; see also Cox, 1997). 7

No satisfying statement of the role of parties in preserving
federalism exists. But the essence of the argument, I believe,
can be summarized as follows. To succeed, federalism must
have an integrated party system, which requires two condi-
tions. First, politicians must have incentives to cooperate across
political levels and jurisdictions in order to win elec-
tions; and second, once in office, political officials must have
incentives to abide by restrictions on their power and refrain
from encroaching on the powers and prerogatives of the other
level. Such a system, for example, may have local politicians
who rely on national brand name or reputation of their party;
and national politicians, unable to create their own independ-
ent national organization to mobilize sufficient votes to cap-
ture power, who must cooperate and mobilize local political
organizations in order to win national elections. In this setting,
political officials across levels must cooperate with rather than
attempt to take advantage of one another. This creates a
vertically integrated political system. 6

Incentives hold the federal system together. Politicians from
the same party at both levels of the federation need one an-
other to win national and local offices. Once in office, officials
at each level are tempted to encroach on the powers and author-
ity of the other. But each has countervailing incentives to
resist such encroachment. The reason is that major encroachments usually create discord between levels; as the
target of encroachment resist s, cooperation fails. Discord and lack of cooperation between levels, in turn, gives the oppo-
site party a competitive advantage in the next election. Be-
cause this outcome makes both national and local officials in
the party worse off, they have incentives to forgo encroaching
on the powers and prerogatives of the other level. In short,
the scholars argue, federal parties are essential to the main-
tenance of a federal system.

This argument has some obvious missing links. For one, we
know too little about how to assemble the institutions of fed-
eralism to balance these incentives in a way that holds the fed-
eration together. 7 For another, this argument ignores the
complication that politicians from the same party may be in
and out of office. Thus, if party A holds power at the national
level while party B holds power in most units at the lower le-
vel, might A be tempted to encroach on decentralization as a
means of weakening the ability of party B to succeed in their
policy goals?

In a second approach, de Figueiredo and Weingast (2005)
model federalism as a repeated game with an initial constitu-
tional period followed thereafter by the following repeated
game (see also Bednar, 2009). In each stage, the federal units
have opportunities to free ride; the center has the authority
to police free-riding, but it may also abuse that authority by
encroaching on the authority of lower governments. In the
constitutional period, the federal states decide whether to
create a federal unit, and if so, to create set limits on the
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