

# 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.

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## 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.<sup>1</sup> 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 study how behavior within real 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.<sup>2</sup> 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 centripetal forces whereby the center captures the powers of the lower jurisdictions; and fissionary 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, Magaloni, & 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 typically inherited or sold when a shareholder dies). Most developing 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 suggest how decentralization can mitigate these problems under some circumstances. This discussion considers some normative aspects of the positive, SGFF ideas, drawing several implications for the design of decentralization. This discussion includes 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 favor inefficient policy choice, especially the inefficient assignment 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 approaches to the assignment problem. Section 4 turns to problems 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 Stepan (2004), emphasize the *two problems of federal stability*. In some federal systems, the national government overwhelms 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 authority. 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 exists. A large literature suggests that certain institutional features of democracy are more likely to preserve decentralization.<sup>3</sup> The literature associates a range of institutions with stable decentralization; for example, when subnational 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 representation in the government (e.g., in a “senate”).

In this section, I summarize four theoretical ideas that contribute 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.<sup>4</sup> 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 compromise 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 government 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).<sup>5</sup>

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 conditions. First, politicians must have incentives to cooperate across political levels and jurisdictions in order to win elections; 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 independent national organization to mobilize sufficient votes to capture 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.<sup>6</sup>

Incentives hold the federal system together. Politicians from the same party at both levels of the federation need one another to win national and local offices. Once in office, officials at each level are tempted to encroach on the powers and authority 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 resists, cooperation fails. Discord and lack of cooperation between levels, in turn, gives the *opposite* party a competitive advantage in the next election. Because 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, these scholars argue, federal parties are essential to the maintenance of a federal system.

This argument has some obvious missing links. For one, we know too little about how to assemble the institutions of federalism to balance these incentives in a way that holds the federation together.<sup>7</sup> 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 level, 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 constitutional 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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