

The Political Economy of Federalism and Decentralization
17.162
Political Science Department
MIT
Fall Term 2002

Instructor: Jonathan Rodden
Phone: 617-253-6261
E-mail: jrodden@mit.edu
Office Hours: 1:00-3:00 PM Tuesdays
Meeting Times: 10:00 AM-12:00 PM Mondays
E51-393

The vertical distribution of governmental authority is rapidly changing around the world. Power and revenue are shifting downward (to state and local governments) and upward (to supra-national bodies like the European Union) at the same time. Moreover, the number of independent countries in the world is rapidly increasing. This course examines theories and empirical studies that explore the causes and consequences of these trends. In so doing, it surveys one of the most vibrant and exciting research areas at the intersection of economics and political science.

Until very recently, most of the systematic theoretical work on multi-tiered systems of government came from the welfare economics and public choice traditions. We take these abstract normative theories as our starting point, but we quickly move beyond them by introducing institutions and politics. In addition to more familiar normative questions, we will examine a variety of positive questions that are at the forefront of the research agenda in political science. In other words, we are interested not only in learning about how multi-tiered governments should work, but also how they actually work in diverse settings around the world. Each week our discussions will examine both the theory and practice of federalism, with applications in developed federations like the United States and Canada, developing federations like Argentina, Brazil, and India, countries in transition like South Africa and Russia, and one very important nascent federation—the European Union. Moreover, some of our discussions will range well beyond the world’s formally federal systems.

Weekly participation in discussion is mandatory [25% of course grade]. Students will write a short (3-5 page) paper in response to the readings for one week [15% of course grade]. Students will present the ideas expressed in the paper, generate discussion questions, and help lead the seminar on the week they choose [10% of course grade]. The most important assignment is an analytical paper (15-25 pages), due on December 22 [50% of course grade].

Sept. 9: *Introduction to the Course*

Sept. 16: *Fiscal Federalism: The Optimal Assignment of Governmental Authority*

We begin with the normative economic theory of federalism, reviewing some of the basic concepts of fiscal federalism theory. Why should state or local governments provide governmental goods and services? In an ideal world, which ones would they provide, and which tasks would be reserved for the central government? Under what conditions might decentralization lead to improvements in accountability and governance? To what extent does the real world resemble the world of welfare economics? Which countries are most decentralized and why? Which countries get it right? Which ones get it wrong and why? Is the European Union on the right track?

- Oates, Wallace. 1999. “An Essay on Fiscal Federalism,” *Journal of Economic Literature*. Vol. 37 (3). p 1120-49.

- Panizza, Ugo. 1999. "On the Determinants of Fiscal Centralization: Theory and Evidence," *Journal of Public Economics* 74: 97-139.
- Inman, Robert and Daniel Rubinfeld. 1992. "Fiscal Federalism in Europe: Lessons from the United States Experience," *European Economic Review* 36: 654-660.
- Rose-Ackerman, Susan. "The Economics and Politics of Federalism: Tensions and Complementarities," *APSA-CP* 11, 1: 17-19.
- Besley, Timothy and Stephen Coate. "Centralized versus Decentralized Provision of Local Public Goods: A Political Economy Analysis," NBER Working Paper 7094.

Sept. 23: Student Holiday—no class.

Sept. 30: *Positive theories of integration and decentralization*

While the European Union and other free trade alliances are coming together, some countries are falling apart (e.g. Czechoslovakia), or threatening to do so (e.g., Canada and Russia). Why do countries fall apart? What are the sources of pressure for fiscal and political (de)centralization? What role do free trade and economic integration play? Are theories of secession a good starting point for understanding the political economy of decentralization?

- Alesina, Alberto and Enrico Spolaore, "On the Number and Size of Nations," *Quarterly Journal of Economics* (November 1997).
- Bolton, Patrick and Gerard Roland, "The Breakup of Nations: A Political Economy Analysis," *Quarterly Journal of Economics* (November 1997).
- Fearon, James and Pieter van Houten. 2002. "The Politicization of Cultural and Economic Difference: A Return to the Theory of Regional Autonomy Movements," unpublished paper, Cambridge University.
- Garrett, Geoffrey and Jonathan Rodden, "Globalization and Decentralization," in Miles Kahler and David Lake, eds., *Globalization and Governance* (Forthcoming, Princeton University Press).
- Arzaghi, Mohammad and Vernon Henderson. 2002. "Why Countries are Fiscally Decentralizing," working paper, Brown University.

Oct. 7: *Why Come Together? Towards a Positive Political Theory of Federalism (First Hour)*

Why do federations form? Did federations as diverse as the United States, Argentina, India, and the European Union form for similar reasons? If federations form to provide collective goods, what are they? If federalism starts with a "bargain" or "contract," what are its key characteristics?

- Riker, William. 1964. *Federalism: Origin, Operation, Significance*. Boston and Toronto: Little, Brown and Company. Preface and Chapters 1-2.
- Iarzcower, Matias, Sebastian Saiegh and Mariano Tommasi, "Coming Together: The Industrial Organization of Federalism," manuscript, Universidad de San Andres.
- Alfred Stepan, "Federalism and Democracy: Beyond the U.S. Model," *Journal of Democracy* 10: 4 (October 1999), p. 19-33.

Federalism and Representation (Second Hour)

Federal bargains often lead to distinctive institutional characteristics. Above all, states and provinces play a role in federal policy-making, and federal bargains affect the legislative process, the relations between the executive and legislature, and the role of the judiciary. In spite of these commonalities, there is also a great deal of diversity among federations in the representation of states and the structure of intergovernmental relations.

- Rodden, Jonathan. 2002. "Comparative Federalism and Decentralization: On Meaning and Measurement," unpublished paper, MIT.
- Watts, Ronald. 1993. "Representation in North American Federations: A Comparative Perspective," in Olson, David and C.E.S. Franks, eds., *Representation and Policy Formation in Federal Systems*. Berkeley: Institute of Governmental Studies, pages 291-321.
- Lijphart, Arend. 1999. *Patterns of Democracy: Government Forms and Performance in Thirty-Six Countries*. New Haven: Yale University Press. Chapters 10-11.

Recommended:

- Arend Lijphart, "The Puzzle of Indian Democracy: A Consociational Interpretation," *American Political Science Review* 90: 2 (June 1996), p. 258-268.
- Cremer, Jacques and Thomas Palfrey. "Political Confederation," *American Political Science Review* 93, 1: 69-82.
- Derthick, Martha. "The Structural Protections of American Federalism," p. 2-23.

Oct. 14: Columbus Day Vactaion

Oct. 21: Mobility and Inter-Jurisdictional Competition

The ability of individuals and firms to "vote with their feet" by moving from one jurisdiction to another has profound implications for governance and accountability. What are the most important implications of inter-governmental competition? Does it make government more efficient? More responsive to citizens? Does it favor certain interest groups over others? What are the implications for redistribution and equality? What are the most important implications for Tiebout's model? What are the testable implications of the papers by Hayek and Buchanan? This week only begins a discussion of mobility and competition that will extend throughout the semester.

- Tiebout, Charles. 1956. "A Pure Theory of Local Expenditures," *Journal of Political Economy* 64, 5: 416-24.
- Friedrich Hayek, "The Economic Conditions of Interstate Federalism," in Friedrich Hayek, *Individualism and Economic Order* (U. of Chicago, 1948).
- Buchanan, James. 1995. "Federalism as an Ideal Political Order and an Objective for Constitutional Reform," *Publius* 25, 2.
- Donahue, John. 1997. "Tiebout? Or Not Tiebout? The Market Metaphor and America's Devolution Debate," *Journal of Economic Perspectives* 11, 4: 73-82.

- Epple, Dennis and Thomas Romer. 1991. "Mobility and Redistribution," *Journal of Political Economy* 99, 4: 828-858.

Oct. 28: Federalism, Economic Growth, and Governance

Arguments about mobility and competition have led to arguments linking federalism to (1) the growth of the private economy, (2) the contraction of the public economy (especially the welfare state), and (3) better governance. This week we address these arguments and ask: Does federalism preserve markets and spur economic growth? Does federalism restrict the growth of the public sector? Is federalism associated with good governance? Or are the answers to these questions conditional on other more important factors?

Economic development:

- Weingast, Barry. 1995. "The Economic Role of Political Institutions: Market-Preserving Federalism and Economic Growth," *Journal of Law, Economics, and Organization* 11: 1-31.
- Rodden, Jonathan and Susan Rose-Ackerman. 1997. "Does Federalism Preserve Markets?" *Virginia Law Review* 83, 7: 1521-72. (Recommended)
- Davoodi, Hamid and Heng-fu Zou. 1998. "Fiscal Decentralization and Economic Growth: A Cross-Country Study," *Journal of Urban Economics* 43: 244-257.

The size of government

- Rodden, Jonathan, "Reviving Leviathan: Fiscal Federalism and the Growth of Government," unpublished paper, MIT.

The welfare state

- Pierson, Paul, "Fragmented Welfare States: Federal Institutions and the Development of Social Policy," *Governance* 8, 4 (1995): 449-78.

Corruption and good governance

- Treisman, Daniel, "Decentralization and the Quality of Government" available at: <http://www.imf.org/external/pubs/ft/seminar/2000/fiscal/treisman.pdf>

Nov. 4: Federalism, interregional inequality, and economic development

Convergence

- Sala-i-Martin, Xavier. 1996. "The Classical Approach to Convergence Analysis," *Economic Journal* 106: 437, p. 1019-36.

Divergence

- Myrdal, Gunnar, *Economic Theory and Under-developed Regions* (London: Duckworth, 1957), Chapter 3.
- Williamson, Jeffrey, "Regional Inequality and Process of National Development: A Description of the Patterns," *Economic Development and Cultural Change* Vol. XIII, No. 4, Part II, July 1965, p. 2-84.

- Rao, M. Govinda, R.T. Shand, and K. P. Kalirajan, "Convergence of Incomes across Indian States: A Divergent View," *Economic and Political Weekly* (India) March 27-April 2, 1999.
- Shankar, Raja and Anwar Shah, "Bridging the Economic Divide within Nations" *Policy Research Working Paper 2717* (Washington, D.C.: World Bank, 2001)
- Ades, Alberto and Edward Glaeser, "Trade and Circuses: Explaining Urban Giants," *Quarterly Journal of Economics* 110, 195-227.

Interpersonal inequality

- Linz, Juan and Alfred Stepan, "Inequality Inducing and Inequality Reducing Federalism," paper presented at the World Congress of the International Political Science Association, August 1-5, 2000, Quebec City, Canada.
- Vincent Mahler, "Exploring the Subnational Dimension of Income Inequality," Luxembourg Income Study Working Paper No. 292. (January 2002). Read pages 1-9 and look at tables and charts.

Nov. 11: No class (Professor Rodden out of town)

Nov. 18: The Problem of Collective Goods in a Federal System

Federations may form to provide their members with collective goods, but in many cases, federal institutions seem to allow private interests to win out over the "public interest." Strategic gaming and bargaining between governments often lead to collectively sub-optimal outcomes. What are the roots of this problem? What are its most serious manifestations? How can it be overcome?

- Treisman, Daniel. 1999. "Political Decentralization and Economic Reform: A Game-Theoretic Analysis," *American Journal of Political Science* 43, 4: 488-517.
- Treisman, Daniel, "Decentralization and Inflation: Commitment, Collective Action, or Continuity?" *American Political Science Review* 94, 4 (Dec. 2000): 837-857.
- Dougherty, Keith. 1999. "Public Goods and Private Interests: An explanation for state compliance with federal requisitions, 1775-1789," in Jac Heckelman et. al. eds. *Public Choice Interpretations of American Economic History*. Dordrecht, The Netherlands: Kluwer Academic Publishing.
- Rodden, Jonathan. "The Dilemma of Fiscal Federalism: Grants and Fiscal Performance Around the World," *American Journal of Political Science* 46(3): 670-687.

Nov. 25: Federalism and Stability

This week addresses the maintenance of a stable federal system. Are federations unstable by design? What accounts for cross-national differences in stability? Why do some initially-decentralized federations stay that way (the United States, Canada, Switzerland), while others centralize (Argentina, Mexico)? What accounts for differences in the discretion given to provincial governments when implementing federal policy? What are the most important conditions under which federations can renegotiate their underlying "bargains?" Why do some federations—perhaps most notably Canada—consistently fail

to do so? Can federalism succeed in South Africa and Russia? The literature addressing these questions focuses on the design of institutions and the role of political parties.

- Riker, William. 1964. *Federalism: Origin, Operation, Significance*. Boston and Toronto: Little, Brown and Company. Chapters 3-4.
- Keleman, Daniel. *The Rules of Federalism: Institutions and Regulatory Politics in the EU and Beyond*, unpublished book manuscript, Chapter 1.
- Ordeshook, Peter and Olga Shvetsova. 1997. "Federalism and Constitutional Design," *Journal of Democracy* 8: 27-42.
- Manor, James. "Making Federalism Work," *Journal of Democracy* 9: 3 (July 1998).
- "A Cacophony of States," *The Economist*, October 16, 1999.
- Rodden, Jonathan. "Creating a More Perfect Union: Electoral Incentives and the Reform of Federal Systems," manuscript, MIT.

Recommended:

- Bednar, Jenna, William Eskridge, and John Ferejohn. 1998. "A Political Theory of Federalism," Unpublished paper, Stanford University.

Dec. 2: *Distributive Politics in Decentralized Systems: Towards a Positive Theory of Fiscal Federalism*

In the first part of the course we discussed how intergovernmental transfers would be devised and distributed in an ideal world where governments are always benevolent. In the real world, however, intergovernmental transfers have much more to do with politics, but we know very little about the comparative political economy of intergovernmental grants. The central question of this week is one of the basic questions of political science: Who gets what, when, and how much? How is this shaped by the institutions of representation? How do federal-level distributive politics games shape the incentives of state-level officials?

- Inman, Robert and Daniel Rubinfeld. 1997. "The Political Economy of Federalism," in Dennis Mueller, ed., *Perspectives on Public Choice: A Handbook*. Cambridge: Cambridge University Press. Pages 73-105.
- Persson, Torsten and Guido Tabellini. 1996. "Federal Fiscal Constitutions: Risk Sharing and Redistribution," *Journal of Political Economy* 104, 5: p. 979-1009.
- Kletzer, Kenneth and Jørgen von Hagen. 2000. "Monetary Union and Fiscal Federalism," Policy Working Paper B01, Center for European Integration Studies, Bonn.
- Dahlberg, Matz and Eva Johansson. 2002. "On the Vote-Purchasing Behavior of Incumbent Governments," *American Political Science Review* 96, 1.
- Gibson, Edward, Ernesto Calvo, and Tulia Falleti. 1999. "Reallocation Federalism: Overrepresentation and Public Spending in the Western Hemisphere," Working Paper, Northwestern University.

Recommended:

- Saiegh, Sabastian and Mariano Tommasi. 2000. "An 'Incomplete-Contracts' Approach to Intergovernmental Transfer Systems in Latin America," working paper, CEDI (recommended).
- Dixit, Avinash and John Londregan. 1998. "Fiscal Federalism and Redistributive Politics," *Journal of Public Economics* 68, 153-180 (recommended).

Dec. 9: *The Problem of Accountability in Multi-Tiered Political Systems*

Federalism and other forms of multi-tiered government may create a problem for democratic accountability. Pundits have identified a similar crisis of "democratic deficit" in such diverse settings as Canada, Australia, and the European Union. How can citizens hold politicians accountable for their actions in a multi-tiered political system? What role do institutions play?

- Seabright, Paul. 1996. "Accountability and Decentralization in Government: An Incomplete Contracts Model," *European Economic Review* 40, 1: 61-89
- Scharpf, Fritz. "The Joint-Decision Trap: Lessons from German Federalism and European Integration," *Public Administration* 66, 239-278.
- Kincaid, John. "Confederal Federalism and Citizen Representation in the European Union," *West European Politics* 22, 2: p. 34-58.
- Lowry, Robert, James Alt and Karen Ferree. "Fiscal Policy Outcomes and Electoral Accountability in the American States," *American Political Science Review* 92, 4: 759-74.
- Besley, Timothy and Anne Case, "Incumbent Behavior: Vote-Seeking, Tax-Setting, and Yardstick Competition," *American Economic Review* 85, 1 (1995): 25-45.
- Remmer, Karen and Francois Gelineau. 2002. "Subnational Economic Voting : Electoral Choice in Argentina, 1983-99. Unpublished paper, Duke University.