

***Creating a More Perfect Union:
Electoral Incentives and the Reform of Federal Systems***

Jonathan Rodden
Assistant Professor
Department of Political Science
MIT
E53-444
77 Massachusetts Avenue
Cambridge, MA 02139
(617) 253-6261
jrodden@mit.edu

Draft Completed July 20, 2001

Word Count: 10,074 (including notes, tables, figures)

Abstract: Federal constitutions are viewed as incomplete contracts that must be renegotiated among self-interested, reelection-seeking politicians. Even when collectively sub-optimal, they are difficult to renegotiate if each state government faces electoral incentives to ignore externalities and federation-wide collective goods. Vertically integrated political parties help resolve this problem by creating "electoral externalities" that encourage politicians to sacrifice private benefits in order to receive credit for reform. Electoral externalities are measured and compared in Australia, Germany, and Canada. Case studies demonstrate that wide-ranging intergovernmental reforms have been compatible with politicians' incentives on several key occasions in Australia and Germany, while the dearth of electoral externalities in Canada has consistently undermined them.

An earlier version of this paper was presented at the 1999 Annual Meeting of the Midwest Political Science Association. The author wishes to thank Harvey Palmer, Susan Rose-Ackerman, and Pieter Van Houten for providing helpful comments, and Campbell Sharman and John Wilson for sharing data.

Major reforms in the structure of intergovernmental relations are high on the political agenda in federations around the world. Although scholars and politicians complain of intergovernmental systems in crisis, reform-- which often requires the consent of the federal government and a supermajority of states—is elusive. Due to the number of veto players and the diverse interests they represent, intergovernmental reforms that could bring long-term benefits to the federation as a whole while jeopardizing the short-term interests of important players are difficult to achieve.

This paper highlights an important political condition under which such reforms are possible, building on an underdeveloped suggestion made by William Riker.¹ Politicians who stand to lose short-term political benefits by voting for reform will do so only if they expect to receive offsetting benefits in the form of political credit. This condition is most likely to be met when political institutions create partisan links between individual politicians at the federal and state levels. That is, state-level politicians are more likely to internalize the social costs of the *policy* externalities they produce if their electoral fates are driven by *electoral* externalities.

After laying out the hypothesized relationship between electoral externalities and reform in sections one and two, section three introduces measures of electoral externalities in three federations. Section four explores the relationship empirically with diachronic and cross-national comparisons, demonstrating that a “joint decision trap” introduces important obstacles to reform in Germany and Australia, but partisan links between federal and state officials make it possible to overcome them. Special attention is given to the overhaul of the German federal system under the Grand Coalition in the late 1960s, and the recent reform of the Australian federal system. In the Canadian federation, on the other hand, intergovernmental reform has been frustrated time and again because provincial leaders have no partisan incentives to be concerned with federation-wide

¹ William Riker and Ronald Schaps, “Disharmony in Federal Government,” *Behavioral Science* 2 (1957).

collective goods. The final section concludes by exploring broader implications for other federations and directions for further research.

I. FEDERALISM AND THE JOINT DECISION TRAP

Federal constitutions are not negotiated by benevolent planners behind Rawlsian veils of ignorance; they are often political bargains that deviate significantly from the optimal distribution of authority laid out in fiscal federalism textbooks. Moreover, federal constitutional contracts are, like contracts between firms, often incomplete. Oliver Hart points out that "The contract is best seen as providing a suitable backdrop or starting point for renegotiations rather than specifying the final outcome."² The assignment of responsibilities between governments in federal systems is not resolved during the original constitutional convention; rather, it is continuously renegotiated through an ongoing intergovernmental bargaining process. A basic problem of federalism is that political incentives may prevent the federal government and states from negotiating and renegotiating intergovernmental contracts that will provide them with collective goods.

More concretely, a group of states might negotiate a federal "bargain"³ in order to achieve some collective goods, like a common defense, currency, or internal market. Such a federation may form from previously independent units, or be created from above to accommodate heterogeneous preferences while preserving federation-wide collective goods.⁴ At the original contracting stage, states are concerned about future expropriation and opportunism on the part of the other states or the federal government, so they will not give up authority without strong institutional protections. In addition to constitutional protections backed up by courts, these

² Oliver Hart, *Firms, Contracts, and Financial Structure* (New York: Oxford University Press, 1995), 2.

³ William Riker, *Federalism: Origin, Operation, Significance* (Boston: Little, Brown, 1964).

⁴ Alfred Stepan, "Federalism and Democracy: Beyond the U.S. Model," *Journal of Democracy* 10 (1997).

contracts usually directly include the states as veto players over key legislative issues and require supermajorities for the re-negotiation of the basic contract.

It may eventually become clear to all of the parties that the division of authority or finances laid out by the original contract imposes significant costs on the federation as a whole. The negotiation of a new contract is no simple matter, however, because the existing arrangement generates private benefits for either the federal government or all or some subset of the states. Even though an alternative contract might promise long-term gains for the federation as a whole, some states might veto it in order to protect their private benefits, or they may negotiate a second-best contract that compensates them for the loss of these benefits. Thus while federations are often formed in the pursuit of collective goods, they may fall prey to a “joint decision trap” that creates status quo bias and undermines the sustained provision of collective goods.⁵

In Riker’s words, “What is important about federalism is the constitutionally assured potential for local governments to disrupt. This is how they act as a restraint on the federal government.”⁶ While some normative studies of federalism admire these restraints and seek to preserve them as roots of economic prosperity,⁷ other recent studies emphasize the costs of a federal “status quo bias” as an impediment to prosperity, especially in developing countries. Studies by Treisman⁸ and Wibbels⁹ suggest that political fragmentation in federations can

⁵ Fritz Scharpf, “The Joint-Decision Trap: Lessons from German Federalism and European Integration,” *Public Administration* 66 (1988).

⁶ Riker, *The Development of American Federalism* (Norwell, MA: Kluwer, 1987), 74.

⁷ See, e.g. Barry Weingast, “The Economic Role of Political Institutions: Market-Preserving Federalism and Economic Development,” *Journal of Law, Economics, and Organization* 11 (1995).

⁸ Daniel Treisman, “Political Decentralization and Economic Reform: A Game-Theoretic Analysis,” *American Journal of Political Science* 43 (1999); “Decentralization and Inflation: Commitment, Collective Action, or Continuity?” *American Political Science Review* 94 (2000).

undermine collective goods like structural reform and macroeconomic management. More specifically, a variety of studies draw attention to the damaging effects of local protectionism and inter-provincial trade wars that subvert one of the most basic federal collective goods-- a national common market.¹⁰ To cite other examples, constitutional compromises might create distributions of taxing and revenue authority that create serious inefficiencies, like regional taxation of natural resources,¹¹ tax exportation¹² or moral hazard.¹³

In each of these examples, state-level leaders receive some sort of private political benefit from perpetuating policies that are inefficient from a national collective goods perspective. Leaders in all of the states may be unwilling to abdicate their autonomy over an important revenue source or their discretion over a spending or regulatory area that is popular with constituents. If the benefits of the inefficient arrangement are concentrated in a small number of states and the costs are diffuse over the entire federation, the political representatives of the beneficiary states are compelled to protect the arrangement, or at least to insist on significant compensation in any new arrangement.

The joint decision trap is of central importance in many formally federal systems, where key institutional and policy changes cannot be made without the consent of the units. Though there

⁹ Erik Wibbels, "Federalism and the Politics of Macroeconomic Policy and Performance," *American Journal of Political Science* 44 (2000).

¹⁰ For a literature review, see Jonathan Rodden and Susan Rose-Ackerman, "Does Federalism Preserve Markets?," *Virginia Law Review* 83 (1997).

¹¹ Richard Musgrave, "Who Should Tax, Where, and What?" in C.E. McClure, ed., *Tax Assignment in Federal Countries* (Canberra: ANU Press, 1983).

¹² M. Govinda Rao and Francois Vaillancourt, "Interstate Tax Disharmony in India: A Comparative Perspective," *Publius* 24 (Fall 1994).

¹³ Jonathan Rodden, Gunnar Eskeland, and Jennie Litvack, eds., *Decentralization and the Challenge of Hard Budget Constraints* (MIT Press, forthcoming).

is a great deal of variation across federations in the number and type of decisions that require such mutual consent, most modern federations do not resemble the notion of “dual federalism” that underlies both traditional American constitutional scholarship and the welfare economics literature on fiscal federalism. Rather than clearly assigning mutually exclusive, water-tight spheres of authority and revenues to federal and state governments, federal constitutions usually create hopelessly intertwined processes of revenue raising, policy formulation, and policy administration at the state and federal levels. States often depend on revenues that are shared between levels or distributed by the federal government as general-purpose grants. Moreover, the success of federal policy-making in an area like welfare may be jeopardized if formulated in isolation from state-level policies in areas like unemployment insurance (and vice-versa). In addition, federal governments frequently rely on state-level bureaucracies to administer their policies. Richard Simeon’s description of Canada is apt for most modern federations:

Governments are interdependent, so that initiatives taken at one level have immediate consequences for the other. The programs available to citizens, and the tax burdens to pay for them, are a combined product of what all the governments do. This suggests that any re-thinking or restructuring of public finances or the welfare state which is to meet the needs of citizens requires a coordinated effort with all the governments working together.¹⁴

This paper examines three prime examples of modern, intertwined federalism. In Germany, revenue collection is carried out through a cooperative process between the *Bund* (central government) and the *Länder* (states), and the revenue autonomy of the *Länder* is severely limited. The *Bund* has a very small administrative apparatus of its own, depending on the *Länder* to administer most of its policies. Moreover, the *Länder* are veto players for most central government policy decisions because of their direct representation (by appointment from the Land governments) in the *Bundesrat* (federal upper chamber). Most policy changes in the German

¹⁴ Richard Simeon, "The Political Context for Renegotiating Fiscal Federalism," in Keith Banting, Douglas Brown, and Thomas Courchene, eds., *The Future of Fiscal Federalism* (Kingston: Queen's University Press, 1994), 136.

federation require either a simple or two-thirds majority of the *Länder*. Although the Australian and Canadian federations approximated the dual federalism ideal prior to World War II, when they presided over their own wide-ranging tax bases and autonomous revenue collection administrations, both moved considerably in the direction of “intertwined” federalism as part of the war effort. In Australia, the central government retained its revenue dominance after the war, and although the constitution does not prevent it, the Australian states do not levy or collect their own income taxes, and most important revenue decisions in Australia are made through a complex intergovernmental bargaining process. Although the Canadian provinces have regained the authority to levy a wide variety of taxes in the post-war period, revenue collection and distribution still require complex ongoing contracting between the provinces and federal government, since in most cases the federal government collects provincial taxes under formal tax collection agreements.¹⁵ In each of these countries, important federal policy objectives are funded through intergovernmental grants, and a variety of important policy areas are the joint responsibility of the federal and constituent governments.

In short, the intertwined fiscal and policy-making processes in each of these federations require the frequent renegotiation of complex intergovernmental contracts. As elaborated in the case studies below, vested interests among state-level politicians almost always make them difficult to renegotiate, and these systems can slip rather easily into socially inefficient but stubborn political equilibria. In Australia and Canada, the joint decision trap has complicated attempts to remove barriers to inter-state trade. In all three countries, it has been difficult to renegotiate arcane intergovernmental fiscal contracts. In Canada, even the basic constitutional contract has been deemed unacceptable by almost everyone for decades, yet reform is notoriously elusive.

¹⁵ There are a few exceptions. Alberta, Ontario, and Quebec collect their own corporate income tax, while only Quebec collects its own personal income tax.

II. BREAKING OUT OF THE JOINT DECISION TRAP: THE ROLE OF ELECTORAL EXTERNALITIES

This presents a question of great theoretical and practical interest: how is it possible to break out of the joint decision trap and reach reform compromises? Riker’s classic work on federalism and political parties hints at an answer. In his most well known book,¹⁶ he seeks to explain why the central government does not “over-awe” the constituent governments; his answer lies in a fragmented, decentralized party system. In an earlier paper,¹⁷ Riker argues that federal-state partisan “disharmony” (control of the states by the federal opposition party) is associated with higher levels of intergovernmental “bickering.” Later, he argued that this “bickering” is the *sine qua non* of federalism, and partisan “harmony”—the presence of a strong, disciplined political party that controls all levels of government (e.g. the Soviet Union)—spells the implicit abandonment of federalism.¹⁸

This paper takes federal “bickering” (here viewed as incomplete contracting) as a given, and turns Riker’s question around—asking instead about the conditions under which intergovernmental disputes can be resolved. The hypotheses presented here have to do with partisan links between levels of government, but they make room for more finely tuned cross-national comparisons. Partisan incentives for intergovernmental cooperation need not imply a stifling Soviet-style partisan hierarchy. On the contrary, a subnational official may face incentives to give up valuable local benefits in favor of national collective goods even if her co-partisans at the center have no formal power to punish or reward her. It is only necessary that her electoral fate be partially determined by federal-level politics.

¹⁶ Riker (fn. 3).

¹⁷ Riker (fn. 1).

¹⁸ Riker (fn. 6).

The reelection chances of individual politicians are often determined not only by what they say and do in their districts, but also by the value of their party labels. In the presence of national political parties that compete at both levels of government, the self-interested activities of a prominent politician at one level may produce positive or negative externalities that affect the reelection chances of politicians with the same party label competing at the other level. In federal systems, the value of this label may be determined partially or almost completely at the federal level. In other words, voters may view state elections as something like referenda on the performance of the governing party or coalition at the central level. In fact, this may be a rational information-economizing strategy on the part of voters. Given the complexity of most intergovernmental contracting systems, it is difficult for voters to follow the flow of revenue and accountability. Especially when revenue collection is largely centralized, voters may economize on information by rewarding and punishing the party of the federal executive at all levels of government. Thus under some conditions state-level politicians may realize that although they receive valuable benefits through the perpetuation of an inefficient intergovernmental contract, they have more to gain by supporting reform, because they will enjoy some of the resulting increase in the value of their party label.

Note that this argument presupposes some amount of “horizontal” party discipline at both levels. If parties simply do not matter for reelection, party labels will not help resolve the federal joint decision trap. The concept of vertical electoral externalities, however, is analytically distinct from the usual notion of party discipline in legislatures-- a federal system might have highly disciplined political parties at both levels of government, but lack vertical electoral externalities. That is, the electoral fates of individual politicians may be linked together by party labels at each level, but they may not be linked across levels. This distinction forms part of the logic for the selection of cases for analysis. Australia, Canada, and Germany have parliamentary systems with strong party discipline at both the federal and state levels, and the strength of the party label is an important determinate of any incumbent’s electoral success. Yet as we shall see, they display variations, both across time and across countries, in the strength of vertical electoral externalities.

The argument can be distilled into two observable implications, one requiring comparisons across countries and the second dealing with changes over time within countries.

H1: Intergovernmental systems without significant electoral externalities will be resistant to reform.

If the state-level leaders are never concerned with protecting or enhancing the value of a federation-wide party label, they will never face incentives to internalize the social costs of their activities. In such a system, private electoral benefits will always win out at the state level, and state leaders will be unwilling to give up their access to these benefits, even if the efficiency losses for the federation as a whole become clear and salient to everyone.

H2: In systems with significant electoral externalities, reform is most likely when the federal government and the governments of the pivotal states are controlled by the same political party.

In other words, reform is most likely when the electoral externalities are positive for the most critical states. For a state-level governing party whose partisan colleagues are in opposition at the federal level, supporting reform that gives political credit to the central government would only create a negative electoral externality.

III. MEASURING ELECTORAL EXTERNALITIES

This argument diverges in a subtle but important way from its predecessors, and thus requires a new approach to measurement. H1 requires a long-term, comparable measure of the extent to which the vote shares of state-level politicians are shaped by those of their partisan colleagues at the federal level. Thus I estimate a simple model of subnational vote share for the most successful party in each federation during the post-war period, pooling but estimating

separate effects for the states from each of the three countries so as to directly compare the significance of coefficients:¹⁹

$$\text{State-Level Vote Share}_{it} = \beta_0 + \beta_1 \text{Corresponding Federal-Level Vote Share}_{it} \times \text{Country Dummy} + \beta_2 \text{State-Level Vote Share}_{it-1} \times \text{Country Dummy} \dots + \text{State Dummies} + \varepsilon$$

The dependent variable is the party's vote share in state *I* in election *T*. The independent variables of interest are the party's aggregate state-level vote shares in the corresponding federal elections.²⁰ In order to compare state and federal voting trends and deal with serial correlation, the party's aggregate vote share in the preceding state election is also included. In order to control for state fixed effects, dummy variables for all of the states are included. The estimation technique is OLS with panel-corrected standard errors. The results are presented in Table One.²¹

¹⁹ For Australia, I analyze the Australian Labor Party (ALP); for Canada, I use the Liberal Party. In Germany, I use the "Union parties"-- the Christian Social Union (CSU) in Bavaria, the Christian Democratic Union (CDU) in the other *Länder*.

²⁰ With occasional exceptions in Germany, state-level elections are not conducted on the same dates as federal elections. The simplest pairing technique would be to use the immediately preceding federal election, but this would pair up, for instance, a federal election that was held three years before rather than one held a few days after the state election. Thus "corresponding" federal elections are coded as follows: (1) use the federal election held within a 12-month period before or after a state election; (2) if a federal election was held during both of these periods, use the preceding election; (3) if no federal election was held during either of these periods, use the most recent federal election held after the preceding state election; (4) if no federal election meets these criteria drop the case from the data set. (This only happens when a minority government at the state level falls quickly and a new election is held).

²¹ Australian data were obtained from Campbell Sharman. Note that no data are included for Western Australia until 1955 because the ALP did not compete in WA until that year. The results from Canadian elections prior to and including 1988 were collected from Frank Feigert, *Canada Votes* (Durham: Duke, 1989). Results for all federal and provincial election held after 1988 were provided by John Wilson at the

[TABLE 1 ABOUT HERE]

First of all, the coefficients for the lagged state election variables are quite similar in each of the three federations. The coefficients for the federal election variable, however, point to an important difference between Canada and the other two federations. For the German CDU and the Australian ALP, strong performance at the federal level is a very good predictor of performance at the state level, and the coefficients are almost identical. These results are significant at the .01 level-- strong evidence of the presence of electoral externalities. Note that in Germany and Australia, the coefficient for the corresponding federal election result is even slightly higher than that for the lagged state election result. In Canada, on the other hand, the Liberal vote at the federal level has no discernible effect on the Liberal vote at the provincial level. Electoral externalities are clearly lacking in Canada.²²

Riker made the only previous attempt to compare partisan “disharmony” across countries by measuring the strength of the federal majority party’s control over state governments.²³ Because of the complications of American presidentialism and bicameralism, the index relied on Shapley-Shubik power indices to gauge partisan strength at each level, and this approach was

University of Waterloo. German data were downloaded from the *Statistisches Bundesamt* (<http://www.statistik-bund.de>). Because only two federal elections have been held since unification, I report data only from the “old” *Länder*.

²² Similar results can be obtained using a variety of different empirical approaches. For instance, the units of analysis can be state-level incumbents rather than parties, but this rules out even the possibility of significant results in Canada since provincial incumbent parties often do not field candidates in federal elections. The independent variable can also be coded as a moving average of federal election results. Additionally, similar results can be obtained using changes rather than levels, generalized least squares, and the generalized method of moments.

²³ Riker (fn. 1).

extended to Canada and Australia.²⁴ As Campbell Sharman notes, however, the power index is a rather odd complication for parliamentary federal systems in which the executive arms of the state and federal governments are the only relevant players in intergovernmental relations. Thus a more simple measure proposed by Sharman for Australia—the share of states controlled by the party of the federal executive—is a useful measure in Canada and Germany as well.²⁵ This index is traced over time for each country in Figure 1.²⁶

[FIGURE 1 ABOUT HERE]

Because of the small number of states in each country, the index swings widely from year to year. Both Australia and Germany experienced brief periods of what Riker would refer to as partisan “harmony” in the late 1960s and 1970, and Australia also in the mid-1940s and early 1990s, though the index in both countries falls as low as 20 percent. The Liberals in Canada enjoyed strong control of Ottawa and the provinces in the early 1940s, but since 1960, the governing party rarely controls more than half the provinces and remarkably, the Liberals controlled no provinces while in power in Ottawa in the early 1980s.

On average over the entire period, the party in power in Canberra controls 58 percent of the states, while the governing party in Bonn controls 53 percent, and for Ottawa the figure is 44 percent. It must be stressed, however, that these are imperfect measures of electoral externalities for the purpose of cross-country comparison. Since federal and state elections are generally not held simultaneously in these countries, the federal government might lose votes in state elections

²⁴ More precisely, Rikers’s index: For any party whose power index in the national government is greater than .5, one minus the power index of that party in the sum of the states.

²⁵ Campbell Sharman, “Discipline and Disharmony: Party and the Operation of the Australian Federal System,” in Sharman, ed., *Parties and Federalism in Australia and Canada* (Canberra: ANU Press, 1994).

²⁶ The index is calculated from data taken from Sharman (fn 25), Feigert (fn 21) *Europea World Yearbook*, various years, and <http://www.jhu.edu/~aicgsdoc/wahlen>.

because of the well-known “mid-term punishment” phenomenon. This phenomenon would put downward pressure on the index, even though it actually demonstrates the *strength* of vertical partisan externalities. Conversely, occasional control of a majority of provinces by the governing party in Ottawa is of little importance since the results in Table 1 demonstrate that the fates of parties with the same name are unrelated.

In short, while the coefficients in Table 1 are a good cross-national measure for H1, the indices displayed in Figure 1 are useful for assessing H2 over time within countries. The former identify the presence or absence of electoral externalities, and the latter point out moments when intergovernmental reform is most likely in systems where externalities are present. The next step is to use this information to understand failure and success in attempts to renegotiate intergovernmental contracts.

IV. CASE STUDIES

It is not possible to give a satisfying historical account of intergovernmental relations in three countries in one paper. Rather, in accordance with the discussion in sections I and II, the illustrative case studies focus on scenarios in which strong demands for intergovernmental reform have been made, and the private interests of key states have provided them with political incentives to scuttle reforms that are viewed as collective goods. In the three federations under analysis, ongoing intergovernmental feuds have complicated the reform of fiscal federalism, the internal economic union, and even the constitution itself. The case studies examine the role of electoral externalities in resolving or exacerbating the most critical disputes in each country.

CANADA

This paper is not the first to point out the separation between provincial and federal party politics in Canada. Throughout the post-war period, provincial and federal party organizations

have grown into almost completely distinct entities.²⁷ They do little to coordinate their electoral strategies, they raise their own funds, select their own candidates and leaders, and party career patterns rarely move between the federal and provincial levels.²⁸ In fact, one of the most trusted campaign strategies at the provincial level in Canada is to harshly criticize the government in Ottawa, even if it is governed by a party with the same name. Without electoral links to federal parties, provincial officials face incentives only to push for a regional private goods agenda. Although scholars and pundits, even Ottawa and most of the provincial governments claim to agree that a new set of multilateral contracts are necessary, intergovernmental compromise is extremely difficult to achieve since provincial officials have no incentives to give up valuable regional benefits.

The basic contracts underlying the Canadian system of fiscal federalism have remained unchanged for several decades, even though the challenges facing the system have changed considerably and there is general consensus that “the existing arrangements are unsustainable.”²⁹ First of all, most observers agree that the outdated “five-province standard” that structures the Canadian equalization scheme needs to be restructured. Second, direct provincial access to revenue from natural resources introduces a number of additional inefficiencies to the system. Third, observers note that major federal-provincial transfer programs—in particular “Established

²⁷ See, e.g. Herman Bakvis, "Political Parties, Party Government, and Intrastate Federalism in Canada," in Campbell Sharman, ed., (fn 25); William Chandler, "Federalism and Political Parties," in Herman Bakvis and William Chandler, eds., *Federalism and the Role of the State* (Toronto: U. of Toronto Press, 1987).

²⁸ The NDP's more integrated structure is the exception. There are also differences across provinces within the (traditionally) dominant parties. For instance, the federal and provincial branches of the Liberals and Progressive Conservatives are much more integrated in the Maritime than elsewhere. See Rand Dyck, "Links between Federal and Provincial Parties and Party Systems," in Herman Bakvis, ed., *Representation, Integration, and Political Parties in Canada* (Oxford and Toronto: Dundurn, 1991).

²⁹ Simeon (fn 14), 135.

Programs Financing" and the "Canada Assistance Plan"—contradicted basic principals of fiscal federalism from their inception in the 1970s, and a variety of unforeseen circumstances have further undermined their usefulness over time.³⁰ In short, Canadian fiscal federalism is a nexus of interlocking intergovernmental contracts that have outlived the political and economic conditions under which they were negotiated. Reform proposals are plentiful, and all agree that real progress requires the cooperation of Ottawa and all of the provinces. Yet the political incentives for this kind of multilateral cooperation are lacking. Intergovernmental cooperation in which regional benefits are sacrificed for national gains will not yield electoral rewards. For example, some provinces benefit from the "five province standard," while others (most notably Alberta) benefit from natural resource taxation. In the absence of electoral externalities, public debates about reforming Canadian fiscal federalism are dominated by "balance sheet federalism," in which each provincial government explains to its voters why each federal proposal is skewed against their interests. Over time, the tenor of these debates encourages the spread of what has been called the "Canadian disease"-- regional envy.

Canadian politicians and pundits are also fond of pointing out that goods, services, capital, and individuals flow more freely across the borders of the member states of the European Union than the borders of the Canadian provinces. The Canadian internal market is surely the most fragmented of all the developed federations.³¹ In a variety of ways, provincial officials respond to politically powerful groups of local workers or producers and introduce regulations and other

³⁰ See Thomas Courchene, *Equalization Payments: Past, Present, and Future* (Toronto: Ontario Economic Council, 1984); Robin Boadway and Frank Flatters, "Fiscal Federalism: Is the System in Crisis?" in Banting, Brown, and Courchene, eds., (fn 14).

³¹ Thomas Courchene, "Preserving and Promoting the Internal Economic Union: Australia and Canada," in Paul Boothe, ed., *Reforming Fiscal Federalism for Global Competition: A Canada-Australia Comparison* (Edmonton: University of Alberta Press, 1996).

policies that discriminate against workers or producers from other provinces, thereby fragmenting the internal market and creating barriers to mobility.³² These barriers prevent Canadians from realizing the full potential gains from inter-provincial trade. A recent study by the Canadian Chamber of Commerce estimates the cost of Canada's internal trade barriers to be \$7 billion per year, or 1 percent of GDP.³³ Intergovernmental negotiations in 1982 and 1994 have addressed the challenge of strengthening the internal market, but in each case, key actors were ultimately unwilling to give up the private political benefits associated with the protection of local workers and producers. First of all, the *Constitution Act, 1982* and the accompanying Canadian Charter of Rights and Freedoms attempted for the first time to incorporate a binding provision relating to individual mobility. Yet in order to obtain provincial support for the Charter, the federal government also agreed to enshrine several impediments to the internal economic union.³⁴ In 1994, the *Agreement on Internal Trade* was signed by all provincial governments, but once again, governments refuse to give up authority that allows them to protect powerful constituents, and the agreement has achieved little.³⁵ In order to secure provincial agreement, it was necessary to include a loophole stipulating that the agreement does not apply to any measure that is part of a “regional economic development” program, which makes the agreement virtually useless.³⁶

³² Several detailed examples are provided in Filip Palda, ed., *Provincial Trade Wars: Why the Blockade Must End* (Vancouver: Fraser Institute, 1994). Examples include beer sales, financial markets, agriculture, commercial transportation, and preferential hiring practices. For an account of a recent full-scale trade war between Quebec and Ontario, see *Globe and Mail*, Sept. 28, 1993: B1-B2.

³³ Dierdre McMurdy, "The Walls that Divide," *Maclean's* v. 109, Sept. 23, 1996, 39.

³⁴ The Charter enshrines the rights of provinces to discriminate against residents of other provinces with respect to land ownership and employment, and the *Constitution Act* protects the right of energy-producing provinces to enact indirect energy taxes. See Courchene (fn 31), 193.

³⁵ *OECD Economic Surveys: Canada* (1998).

³⁶ Courchene (fn 36), 212.

In addition to fiscal contracts and free trade agreements, the reform of the most basic underlying intergovernmental contract—the Constitution—requires the agreement of Ottawa and all of the provinces. Canada's lack of partisan links between provincial and federal elected officials is an important part of the explanation for its constitutional impasse. On an issue like Senate reform, for example, on which each of the regions has a distinct set of interests, no province faces incentives to compromise for the good of the federation as a whole. The constitutional negotiations (or those over free trade or fiscal federalism) would likely play out much differently if a vertically integrated party with a strong base in each of the provinces would come to power in Ottawa by promising far-reaching constitutional reform. The current fragility of Canada's constitutional contract is not a necessary artifact of the rift between its two main cultural-linguistic groups. The Maritimes, Ontario, and above all the Western provinces have also emerged as important veto players with distinctive demands. The simultaneous satisfaction of these demands is impossible, and compromise will be difficult without electoral externalities. Alberta, British Columbia, and Quebec have been dominated by regional parties. Above all, perhaps some of the strong rhetoric and ill will between Ottawa and Quebec would have been diffused if the provincial and federal branches of the Liberal party had not broken their links in 1964.

AUSTRALIA

In marked contrast to Canada, the state and federal parties in Australia cooperate closely in funding and conducting election campaigns at each level, state elites play important roles in the endorsement of candidates running for federal office, and party careers frequently move back and forth between levels of government.³⁷ State elections are frequently "treated almost as federal by-elections," which "are taken as judgments upon the Prime Minister and the leader of the Federal Opposition as much as upon the state party leaders."³⁸

³⁷ Joan Rydon, "The Federal Structure of Australian Political Parties," *Publius* 18 (1988); Sharman (fn 25).

³⁸ Rydon (fn 37), 168-69.

Some of the same intergovernmental contracting problems—most notably barriers to free trade and competition—have plagued the Australian federation. Unlike Canada, however, electoral externalities have helped facilitate reform. The most dramatic episode took place between 1990 and 1996. At the end of the 1980s, the federal and state governments alike faced a growing public perception of economic crisis-- above all, nationally organized business groups and the media complained of anti-competitive practices, monopoly provision of key goods and services by state-owned enterprises, and an over-regulated economy with many unnecessary impediments to interstate trade and competition. The Hawke government responded by making microeconomic and public sector reform the center of its political agenda. Although some of this agenda could be implemented by the Commonwealth government alone-- e.g. a floating exchange rate, tariff reduction, and deregulation-- much of the agenda required the active participation of the states. In fact, some of the most important reforms required that the states give up their access to regulatory and other policy tools that allowed them to provide key constituents with electorally valuable private benefits.

The timing of the most sweeping intergovernmental reforms in the post-war period is explained by H2. Returning to Figure 1, note that during the period of negotiation, the federal government and five of the six states were controlled by the Labor Party. The states were willing to give up key private benefits because of the offsetting gains in political credit for the successful implementation of reform. New South Wales was the only state controlled by the opposition Liberal party, and its premier, Nick Greiner, who had come to power with a platform favoring microeconomic and public sector reform, had nothing to gain by being the lone hold-out.

The states had to give up important private benefits in order to improve the internal economic union and reform public sector enterprises. One of the key complaints addressed in the Australian intergovernmental negotiations resonates with the discussion of Canada above; the states were able to regulate the sale of goods and services and the registration of occupations in ways that served their own regional interests, but fragmented the internal economic union. In October of 1990, the Australian Heads of Government agreed to an ambitious program of mutual

recognition of regulations and standards relating to the sale of goods and the registration of occupations. In 1991 the states also negotiated agreements on a uniform approach to food standards and the joint regulation of non-bank financial institutions. After the successful implementation of the Mutual Recognition Agreement, Australia's internal union now rivals Germany's as the most integrated of all federal systems.

The intergovernmental agreement on a national competition policy was perhaps the most sweeping and significant of the microeconomic reforms of the early 1990s in Australia. One of the most important factors suppressing competition and a free inter-state market was the role of the states in setting up and protecting public-sector monopolies in key utilities, transportation infrastructure, and several other areas. The efficiency losses associated with these monopolies for the federation as a whole were well known. Nevertheless, the states had been extremely reluctant to give up any authority over these public enterprises, especially since the monopoly rents from these enterprises made up the largest single component of own-source state revenue.³⁹ The final *Competition Principles Agreement*, signed by the Council of Australian Governments in 1995, compensates the states for some of this lost revenue in return for the implementation of reforms, and thus represents a major renegotiation of the fiscal contract as well. It is remarkable that the states were willing to give up the rents, both political and economic, associated with the monopolies. The agreement undoubtedly entailed not only fiscal but political costs for the states, who faced pressure from local interest groups like taxi drivers whose monopoly has been opened up to competition, but they were confident that the offsetting credit for reform would outweigh these costs. The agreement covers all of the public monopolies and state enterprises in gas, electricity, water, rail, urban transit, ports, agricultural marketing boards, and several other areas. According to the OECD, the agreement has produced quick results.⁴⁰ The negotiations also led to

³⁹ John Craig, "Australia," in Teresa Ter-Minassian, ed., *Fiscal Federalism in Theory and Practice* (Washington, D.C.: IMF, 1997), 180.

⁴⁰ *OECD Economic Surveys: Australia* (1997).

repeals and alterations of a wide range of redundant or poorly coordinated regulatory policies at the federal and state levels.

GERMANY

Like state elections in Australia, *Land* elections in Germany are widely seen as the equivalent of federal by-elections; they often amount to referenda on the competence of the Chancellor and his government.⁴¹ As in Australia, the *Bund* and *Land* parties coordinate their funding and campaign activities, *Land*-level leaders play an important part in the nomination process for federal party leaders, and career paths frequently move back and forth between federal and state politics.⁴² The evolution from state-based to highly integrated parties over the post-war period was shaped largely by the incentive structure of the upper chamber of parliament. The *Bunderat* may set the joint decision trap in the first place (by directly including the states as veto players in federal policy), but it also provides the means to break out of it. Opposition parties learned to use the obstructive capacity of the *Bundesrat* to frustrate the governing coalition, effectively turning *Land* elections into federal legislative elections and ultimately creating electoral externalities.⁴³ A brief look at ongoing intergovernmental fiscal negotiations in Germany

⁴¹ Georg Fabritius, *Wechselwirkungen zwischen Landtagswahlen und Bundespolitik* (Meisenheim: Verlag Anton Hain, 1978); Susanne Lohmann, David Brady and Douglas Rivers, "Party Identification, Retrospective Voting, and Moderating Elections in a Federal System: West Germany, 1961-1989," *Comparative Political Studies* 30 (August 1997).

⁴² For example, almost every modern Chancellor started his career with years of service in the party's *Land*-level organization and served as a *Land*-level minister-president. Movements from federal to *Land*-level politics are also common.

⁴³ Heidrun Abromeit, "Die Funktion des Bundesrates und der Streit um seine Politisierung," *Zeitschrift für Parlamentsfragen* 13 (1982); Gerhard Lehbruch, "Institutional Linkages and Policy Networks in the Federal System of West Germany," *Publius* 19 (Fall 1989).

will show that intergovernmental contracts are indeed difficult to renegotiate—especially during periods of divided government—but as in Australia, electoral externalities occasionally open windows of opportunity.

Part of the German Basic Law—the *Finanzverfassung* (fiscal constitution)—contains very specific provisions relating to the division of taxing and spending powers between the *Bund* and *Länder*. Such a specific constitutional contract can only produce acceptable outcomes for a limited period of time, and ultimately it must be renegotiated to accommodate changing circumstances. Periodic renegotiation is especially important given that the states are responsible for implementing most federal legislation, and the Basic Law stipulates that "living conditions" should be "equivalent" throughout the federation. The constitution, especially as it pertains to equalization and other transfers from wealthy to poor *Länder*, is difficult to renegotiate. Contributors, for instance, are not easily convinced that their burden should be increased, while recipients have come to see transfers as constitutionally guaranteed entitlements. Indeed, the basic fault line in most attempts to renegotiate fiscal contracts in Germany is that between the wealthy and poor *Länder*.⁴⁴

Yet the *Bund* and *Länder* have managed to renegotiate basic fiscal contracts on several occasions. The first of these was in 1955. Although the *Bundestag* and *Bundesrat* were both controlled by the Union parties, important conflicts arose between the government in Bonn (especially the CSU finance minister) and the CDU-led governments of Nordrhein-Westfalen and Rheinland-Pfalz . The CDU and CSU went to great lengths to hold extensive talks and prevent the public perception of fragmentation in the coalition, however, and they were eventually able to work out a compromise within the party that brought about the concessions necessary to conclude the reform.⁴⁵

⁴⁴ After unification, the dynamics have become even more complicated, with the interests of the "old" poor *Länder* sometimes conflicting with those of the "new" poor *Länder* in the East.

⁴⁵ Wolfgang Renzsch, *Finanzverfassung und Finanzausgleich* (Bonn: Dietz, 1991), 161.

By the middle of the 1960s, the intergovernmental fiscal contract had once again become outdated. The basic assignment of fiscal and regulatory tasks was widely perceived by the media, the public, and by the *Bund* and *Länder* themselves to be in need of major reform. Furthermore, the *Bund* and *Länder* both carried out uncoordinated industrial subsidy programs as part of their sectoral and regional development programs. The *Länder* competed against one another for limited mobile investment capital, often outbidding each other with subsidy programs.⁴⁶

In general, "it was widely felt that the action space and the action perspectives of the *Länder* governments were too narrowly circumscribed to deal effectively with some of the problems that had become major political issues in the 'reformist' political climate of the mid-1960s."⁴⁷ As with the reform of the Australian intergovernmental system in the 1990s, the reform proposals circulated in Germany in the 1960s required that the *Länder* tie their hands and give up a considerable amount of policy and revenue autonomy in favor of a more multilateral cooperative process. Some of the *Länder*-- most notably Bavaria-- were reluctant to give up any autonomy over their own budgets.⁴⁸ As in 1955, the most important conflict was between the wealthy and the poor *Länder*. In particular, the sweeping reform proposal adopted by the federal government was opposed by the wealthy *Länder*, who felt that the costs of the original reform proposal would fall disproportionately on them. Since the proposal required a two-thirds majority in the *Bundesrat*, the veto threats of the wealthy *Länder* were potentially fatal.

The reform proposal ultimately was accepted by a super-majority of the *Länder* because of the importance of electoral externalities. In the mid-1960s the SPD took advantage of the

⁴⁶ Fritz Scharpf, Bernd Reissert and Fritz Schnabel, *Politikverflechtung: Theorie und Empirie des kooperativen Föderalismus in der Bundesrepublik* (Kronberg: Scriptor, 1976), 77-78.

⁴⁷ Scharpf (fn 5), 244.

⁴⁸ This paragraph and the next draw heavily on Renzsch (fn 45), 246-260, and Renzsch, "Konfliktlösung im parlamentarischen Bundesstaat," in Rüdiger Voigt, ed., *Der Kooperative Staat: Krisenbewältigung durch Verhandlung?* (Baden-Baden: Nomos, 1995), 179-182.

popularity of the intergovernmental reform issue and made it into the centerpiece of its electoral platform. Both major parties were ultimately able to legitimize the formation of a grand coalition because they promised to use it as an opportunity to achieve the two-thirds majority necessary in both houses to renegotiate the constitution. After a long period in opposition, the SPD was particularly anxious to prove to the public that it was capable of delivering on the reform program, and some of the wealthy SPD *Länder*,⁴⁹ even though they had serious reservations about the proposal, were ultimately willing to compromise in order to allow their party to claim credit for successful reform. Had they held out in opposition to the proposal that had been negotiated and heralded by their SPD colleagues in the *Bundestag*, they may have undermined their party's credibility, and hence their own political futures. Partisan links also facilitated Bavaria's eventual vote for reform—heavy lobbying efforts by Franz-Josef Strauß, federal finance minister and CSU head, helped sway the state government.⁵⁰

In the period since the Grand Coalition, Figure 1 provides a fairly good guide to further contract renegotiation. From 1969 to 1982, a coalition between the Social Democrats and Liberals controlled the *Bundestag*, but the Union parties had a majority in the *Bundesrat*. During this period, negative electoral externalities prevented any renegotiation of the intergovernmental fiscal contract, even though it had once again become outdated. In the mid-1980s, however, a CDU-Liberal coalition came to power at the federal level, giving the Union parties temporary control of both chambers. Alterations of the fiscal contract took place during this period directly between the federal government and the so-called "B-Länder"—those under the control of the CDU or CSU.⁵¹ A conference committee to resolve conflicts between the *Bund* and *Länder* was called for 16 percent of the legislation passed by the *Bundestag* during the period of divided government between 1969 and 1982, but for only 2.5 percent of the legislation passed between 1983 and

⁴⁹ In particular, Bremen, Hamburg, Hessen, and Nordrhein-Westfalen.

⁵⁰ Renzsch (fn 45), 259.

⁵¹ Renzsch (fn 48 1995), 176-79.

1991.⁵² When both houses are controlled by the same party, the federal government and its partisan colleagues in the *Länder* face strong electoral incentives to avoid calling the conference committee or allowing for open intergovernmental conflict, lest they present to the public the impression that the party is fragmented or incompetent. It is useful for the Chancellor to develop collaborative working relationships with his party colleagues in the *Länder*. Moreover, many *Land*-level politicians are unwilling to gain a reputation for excessive regional self-seeking because they have aspirations in federal party politics. In fact, making costly concessions in intergovernmental negotiations is a way for *Land*-level leaders to signal to federal party leaders the credibility of their commitment to the overall success of the party.

Very recently, Germany's underlying fiscal contract is coming under fire once again in the wake of reunification. The 1995 agreement to incorporate the new *Länder* into the *Finanzverfassung* is widely criticized, especially by the wealthy *Länder*. In the wake of bailouts of Bremen and Saarland and growing fiscal irresponsibility among the *Länder*, demands for a complete overhaul of the system are growing.⁵³ The evolving arrangement of partisan and fiscal interests, however, will make reform extremely difficult. Any effective reform to improve incentives would require the agreement of some of the poor *Länder*, which will be very difficult to achieve. The SPD-led central government has few incentives to introduce serious reform since its support is drawn disproportionately from the poor *Länder*, while the *Länder* that have the most to gain from reform are controlled by the opposition Union parties. As a result, the wealthy *Länder* are relying increasingly on the courts as the arena for their complaints. As Riker would put it, due to partisan disharmony, intergovernmental “bickering” is once again out in the open.

V. TOWARDS A COMPARATIVE THEORY OF INTERGOVERNMENTAL RELATIONS

⁵² Unpublished data collected by the *Bundesrat*, Geschäftsstelle des Vermittlungsausschusses (1997).

⁵³ See Paul Bernd Spahn and Wolfgang Föttinger, "Germany," in Ter-Minassian, ed. (fn 29).

These short case studies illustrate the role of electoral externalities in shaping the *outcomes* of key intergovernmental conflicts. But it is also possible to extract some broader lessons about the *process* of intergovernmental relations. The intergovernmental contracting processes in Australia and Germany have become increasingly formalized and institutionalized throughout the post-war period. In fact, the two path-breaking intergovernmental reform episodes discussed above—Australia in the 1990s and Germany in the 1960s—also involved important shifts in the arenas of intergovernmental decision-making. An important part of the Australian reform agenda, and in some respects a requirement for its success, was the development of a more collaborative multilateral process of intergovernmental relations. During the early 1990s, the format and procedures of the Premiers Conference were changed, and a series of "Special Premiers Conferences" were convened to deal with more wide-ranging, long-term issues. These eventually formalized into the Conference of Australian Governments. Part of the reason the states were willing to sign the Mutual Recognition and Competition Principles agreements is that the states are now well represented in the bodies that oversee, enforce, and implement them.⁵⁴ In essence, the Australian states were willing to tie their hands and bind themselves to a multilateral arrangement.

A very similar story can be told about the German reforms, which transferred some of the previously distinct revenue and responsibilities of the *Bund* and *Länder* to a proliferation of new policy-specific, intergovernmental bargaining arenas described by Scharpf et al.⁵⁵ In both Germany and Australia, since state-level leaders realize that their electoral fates are partially out of their hands, they have weaker incentives to hold out and pursue aggressive regional agendas, and stronger incentives to cede unilateral authority over revenue and policy decisions to multilateral bodies.

⁵⁴ Specifically, the National Competition Council (NCC) and the Australian Competition and Consumer Commission (ACCC).

⁵⁵ Scharpf, et al. (fn 46).

In Canada, on the other hand, provincial governments have incentives to jealously guard their jurisdictional and fiscal turf. A common observation is that federal-provincial relations resemble international diplomacy, and often Ottawa's only option is to negotiate separate bilateral deals with individual provinces.⁵⁶ In contrast to Australia and Germany, where intergovernmental pacts and oversight bodies serve to coordinate joint involvement in the same policy field, each Canadian government often proceeds as if the other does not exist. Kenneth McRoberts refers to this as "double unilateralism."⁵⁷ In the absence of electoral externalities, each government is concerned only with receiving credit (or avoiding blame) for its own activities. Thus each level is eager to enter any policy domain—even one already dominated by the other level—that might provide it with access to electoral benefits.⁵⁸ Attempts at federal-provincial collaboration in the provision of public goods often break down in federal-provincial disputes over credit claiming. For instance, Donald Savoie argues that the federal government backed out of jointly funded regional development programs because the provinces were perceived as receiving too much credit, opting instead to fund its own regional development initiatives that ultimately competed

⁵⁶ Richard Simeon, *Federal-Provincial Diplomacy* (Toronto: U. of Toronto, 1972).

⁵⁷ Kenneth McRoberts, "Unilateralism, Bilateralism, and Multilateralism: Approaches to Canadian Federalism," in Richard Simeon, ed., *Intergovernmental Relations* (Toronto: U. of Toronto, 1985), 94.

⁵⁸ See, e.g. Rodney Haddow, "Federalism and Training Policy in Canada: Institutional Barriers to Economic Adjustment," in Francois Rocher and Miriam Smith, eds., *New Trends in Canadian Federalism* (Peterborough, Ont.: Broadview, 1995).

with those of the provinces.⁵⁹ Moreover, recent studies⁶⁰ suggest that uncoordinated federal and provincial sales taxes lead to over-fishing of a common tax base.⁶¹

That is not to say that Canadian federalism is, in some aggregate sense, less efficient than German or Australian federalism. Indeed many would argue that Canada's increasingly loose, extremely decentralized and uncoordinated form of federalism has served its citizens well, in spite or recent brushes with disintegration. Moreover, the increasingly complex, coordinated form of federalism practiced in Australia and Germany clearly has costs in terms of efficiency and perhaps even democratic accountability. But the point of this paper is positive rather than normative. When electoral externalities are lacking, incentives favor a more combative style of intergovernmental politics, and multilateral contracts are difficult to renegotiate-- even when public demand for reform is strong. As recent Canadian history has shown, this can lead to a centrifugal evolutionary pattern.⁶² When the electoral fates of federal and subnational officials are linked, demands for far-reaching multilateral reform can be satisfied, and a more collaborative, centripetal style of intergovernmental relations can evolve. When demand for reform is strong and

⁵⁹ Donald Savoie, "Regional Development: A Policy for All Seasons," in Rocher and Smith, eds. (fn 58).

⁶⁰ Bev Dahlby, "The Distortionary Effect of Rising Taxes," in R. Robson and W. Scarth, eds., *Deficit Reduction: What Pain; What Gain?* (Toronto: C.D. Howe Institute, 1994); Bev Dahlby and L.S. Wilson, "Tax Assignment and Fiscal Externalities in a Federal State," in Paul Boothe, ed. (fn 31).

⁶¹ It is interesting to note that a Canadian economist models federalism as a vertical competition between rival federal and provincial suppliers of "government output"—a notion that would probably not occur to a student of Australian or German federalism. See Jean Luc Migué, "Public Choice in a Federal System." *Public Choice* 90 (1997).

⁶² See also Pieter Van Houten, "Regional Assertiveness in Western Europe: Political Constraints and the Role of Party Competition," typescript, Oxford University, arguing that the absence of nationally organized political parties leads to demands for decentralization.

electoral externalities are properly aligned, as in the 1960s in Germany and the 1990s in Australia, a federation may face a “constitutional moment” for intergovernmental reform.⁶³

Although there is no guarantee that such reform pacts will lead to the optimal intergovernmental contracts envisioned by economic theory, the ability to achieve periodic multilateral reform might be critical for the long-term viability and success of federations—especially in developing and transition countries. Peter Ordeshook’s work on Russia points out that vertical partisan links are lacking, and its intergovernmental process is strikingly similar to Canada’s: “Moscow negotiates bilateral agreements with individual republics and regions as if it were conducting diplomatic relations with foreign powers.”⁶⁴ The costs of this style of intergovernmental politics—for economic efficiency and political stability—may be much higher in Russia than in Canada.

The challenge of renegotiating intergovernmental contracts is especially vexing in large, decentralized federal democracies where state or provincial governments face strong political incentives to pursue regional agendas. The ‘joint decision trap’ is a central feature of many developing federations like India, Argentina, and Brazil. In each of these countries, the inability to renegotiate inefficient intergovernmental fiscal contracts has allowed moral hazard and mounting subnational debts to undermine overall fiscal stability.⁶⁵ Moreover, the opportunity costs of suppressed gains from inter-provincial trade in the presence of local protectionism are likely much higher in these countries than in Canada, and in many such developing federations, key public sector reforms like privatization require the active cooperation of subnational officials. Electoral externalities likely play a critical role in facilitating or frustrating needed intergovernmental

⁶³ Bruce Ackerman, *The Future of the Liberal Revolution* (New Haven: Yale, 1992).

⁶⁴ Peter Ordeshook, “Russia’s Party System: Is Russian Federalism Viable?” *Social Science Working Paper* 962 (California Institute of Technology, 1996), 6.

⁶⁵ Rodden, et al. (fn 13).

compromises, and can help scholars understand cross-national variations in fiscal federalism, inter-state commerce, and even overall political stability.

For example, like the Liberal Party in Canada, the decline of the Congress Party in India has weakened electoral externalities, with important implications for intergovernmental relations. While in the past, career-oriented state leaders faced incentives to lower their demands and reach intergovernmental agreements within the party, central governments in India today are often loose, unstable coalitions of regional parties, none of which have encompassing electoral interests in the federation as a whole. Each of the regional parties has incentives to press its regional demands at the center, and electoral incentives for compromise are lacking. As a result, key reforms of fiscal institutions, the inter-state market, and public sector enterprises remain elusive, not to mention political stability.

The catastrophic failures of the intergovernmental fiscal contracting systems in Brazil and Argentina in the 1980s are well known, and in both countries, the “joint decision trap” has made renegotiation extremely difficult.⁶⁶ William Dillinger and Stephen Webb suggest that there is greater reason for optimism in Argentina, however, because of vertical links between federal and provincial politicians. Specifically, they point out that President Menem was able to convince recalcitrant provincial politicians from his party to give up private benefits and support fiscal adjustment because they realized that their own reelection chances were bound up in their party’s ability to demonstrate competence in reducing inflation.⁶⁷ Lacking even horizontal discipline, on

⁶⁶ Sabastian Saiegh and Mariano Tommasi, “An Incomplete Contracts Approach to Intergovernmental Transfer Systems in Latin America,” typescript, Universidad de San Andres.

⁶⁷ Dillinger and Webb, “Fiscal Management in Federal Democracies: Argentina and Brazil.” *Policy Research Working Paper 2121* (Washington, D.C: World Bank, 1999). See also Mark Jones, Pablo Sanguinetti, and Mariano Tommasi, “Politics, Institutions and Fiscal Performance in a Federal System: An Analysis of the Argentine Provinces.” *Journal of Development Economics* 61 (2000), arguing that governors

the other hand, Brazil's parties are much less likely to give state governors incentives to give up valuable benefits. In fact, as in post-Congress India, it appears that the political fates of federal politicians are determined in good part by the popularity of state-level co-partisans—precisely the opposite of the German or Australian relationship.⁶⁸ The same is certainly true of elections in the European Union. Important goals for future research are to (1) improve the measures presented in this paper to identify such examples of “reverse coat-tails” and (2) examine the likely centrifugal implications of these incentives for intergovernmental contracting.

This paper contributes to a recent renaissance in the study of comparative federalism and intergovernmental relations. Scholars now realize that federalism is not a binary concept, and its purported normative effects—ranging from secure markets and prosperity to corruption and inflation—depend on the precise arrangement of institutional incentives. Riker was on the right track, and party organization should take center stage once again in positive political theories of federalism.⁶⁹ This paper has proposed arguments and measurements that can be directly applied in a number of contexts and tweaked to fit others.

In addition to the further applications suggested above, future research should attempt to make electoral externalities endogenous. If architects of Russian or EU institutions wanted to promote electoral externalities, what would they do? Some suggestions have been made in passing,⁷⁰ but no systematic comparative research has been done. The case studies in this paper provide some hints and foundations for further research. Ordeshook argues that simultaneous elections for federal and state officials have facilitated links between the two levels in the United

controlled by the same party as the president face incentives to internalize externalities when making fiscal decisions.

⁶⁸ On Brazil, see, e.g. Barry Ames, “The Reverse Coattail Effect: Local Party Organization in the 1989 Brazilian Presidential Election,” *American Political Science Review* 88 (March 1994).

⁶⁹ See, e.g. David Samuels, “Six Articles in Search of a Subject,” *APSA-CP* 11 (Summer 2000).

⁷⁰ See Ordeshook (fn 64); Sharman (fn 25); Samuels (fn 69).

States,⁷¹ but Germany and Australia have very integrated party systems without simultaneous elections. The mechanism of leadership selection within parties also plays an important role. When regional leaders play a strong role in selecting federal party leaders and renewing their mandates, as in Germany and Australia, the parties are more likely to be integrated on a variety of other dimensions. Perhaps the most important factor is the nature of the upper house. The discussion of the German *Bundesrat* above demonstrates that Federal upper houses have the potential to integrate federal and regional-level parties. If the German *Bundesrat* is the most integrative upper house, the Canadian Senate—which is appointed by the federal government—is surely at the opposite end of a spectrum. Additionally, as suggested above, voters might use national party labels to assess credit and blame to state-level politicians in the face of limited or confusing information about local performance. For example, when state governments have very little autonomous authority to levy and collect broad-based taxes, as in Germany and Australia, it makes little sense to hold state officials accountable as if they were autonomous entities. Finally, future studies of electoral externalities should take seriously the constraining role of language, culture, and economic disparities.

Since inter-regional inequalities are large and growing in much of the world, and resources and authority continue to shift from central to subnational governments, the challenge and importance of negotiating successful intergovernmental contracts will only grow. If electoral externalities can facilitate peaceful compromise, studies of their origins should be at the top of the research agenda in comparative politics.

⁷¹ Ordeshook (fn 64).

Table 1: Determinates of State-Level Vote Share for Major Parties in Three Federations

		Australia (ALP)	Canada (Liberals)	Germany (CDU)
Federal Vote Share		0.492 *** (0.10)	0.102 (0.09)	0.528 *** (0.15)
Lagged State Vote Share		0.421 *** (0.11)	0.617 *** (0.11)	0.508 *** (0.09)
Constant	13.901 (6.46)			
Observations (Total)	321			
By country		91	125	105
Number of States (Total)	26			
By country		6	10	10
Years		1946-1992	1947-1993	1954-1994
R-square	0.95			

Panel-corrected standard errors in parentheses

*** significant at 1%

Estimation: OLS with panel-corrected standard errors, fixed effects.

Results for state dummies not shown.

Figure 1: Share of States Controlled by the Party of the Federal Government in Australia, Canada, and Germany

