

The Political Economy of Federalism and Decentralization
17.162
Political Science Department
MIT
Fall Term 2001

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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, introducing institutions and politics to the picture. 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 and Brazil, countries in transition like South Africa and Russia, and one very important nascent federation—the European Union.

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 [25% of course grade], and present their ideas in an oral presentation [10% of course grade]. The most important assignment is an analytical paper (15-25 pages), due on December 22 [40% of course grade].

Sept. 7: *Introduction to the Course*

I. Normative Theories of Federalism and Decentralization

Sept. 14: *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?

- 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. 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? 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.
- 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.
- Rogowski, Ronald. "Policy Setting and Factor Mobility." Unpublished paper, UCLA.

Sept. 28: *Federalism, Economic Growth, and the Size of Government*

Arguments about mobility and competition have led to two distinct arguments linking federalism to (1) the growth of the private economy and (2) the contraction of the public economy. This week we address both of these arguments and ask: Does federalism preserve markets and spur economic growth? Does federalism restrict the growth of the public sector? Or are the answers to these questions conditional on other more important factors?

- Weingast, Barry. 1995. "The Economic Role of Political Institutions: Market-Preserving Federalism and Economic Growth," *Journal of Law, Economics, and Organization* 11: 1-31.
- Qian, Yingyi and Barry Weingast. 1997. "Federalism as a Commitment to Preserving Market Incentives," *Journal of Economic Perspectives* 11, 4: p. 83-92.

- Rodden, Jonathan and Susan Rose-Ackerman. 1997. "Does Federalism Preserve Markets?" *Virginia Law Review* 83, 7: 1521-72.
- Davoodi, Hamid and Heng-fu Zou. 1998. "Fiscal Decentralization and Economic Growth: A Cross-Country Study," *Journal of Urban Economics* 43: 244-257.
- Stein, Ernesto. 1999. "Fiscal Decentralization and Government Size in Latin America," *Journal of Applied Economics* 11 (2), p. 357-391.

Oct 5: No Meeting

Oct. 12: *Federalism and Political Theory*

Now that we have addressed normative economic theories of federalism, we turn our attention to political theory. For an introduction to the subject of political federalism, we turn to the concepts and debates that were addressed by Alexander Hamilton, John Jay, and James Madison in the *The Federalist*.

- Ostrom, Vincent. 1987. *The Political Theory of a Compound Republic*. Lincoln: University of Nebraska Press. Entire book.

II. Positive Political Theories of Federalism

Oct. 19: *Why Come Together? Towards a Positive Political Theory of Federalism*

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.
- Iarczower, 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.

Oct. 26: *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.

- 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. 2000. "The Dilemma of Fiscal Federalism: Hard and Soft Budget Constraints around the World," Unpublished paper, MIT.
- Wibbels, Erik. 2000. "Federalism and the Politics of Market Reform," Forthcoming *American Journal of Political Science*.

Nov. 2: *Federalism and Stability: The Role of Political Parties*

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 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? In order to address these questions, we will pay special attention to the role of political parties.

- Riker, William. 1964. *Federalism: Origin, Operation, Significance*. Boston and Toronto: Little, Brown and Company. Chapters 3-4.
- Bednar, Jenna, William Eskridge, and John Ferejohn. 1998. "A Political Theory of Federalism," Unpublished paper, Stanford University.
- Ordeshook, Peter and Olga Shvetsova. 1997. "Federalism and Constitutional Design," *Journal of Democracy* 8: 27-42.
- Inman, Robert. "Fiscal Federalism in Developing Countries: Lessons Learned from Working in South Africa," *APSA-CP* 11, 1: 11-16.
- James Manor, "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).

Nov. 9: *Federalism and Representation*

Many of the problems of federalism that we have addressed thus far—instability, underprovision of public goods, and soft budget constraints, for example—may be shaped by the way in which subnational governments (and their citizens) are represented in the central government. How do different federal institutional shape the agency relationship between citizens and government? Which structures are most appropriate in which contexts? Some specific issues: What kind of representation structure is likely to work best in the European Union? Should Canada reform its Senate?

- 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.
- 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.
- Re-read the Stepan article from October 19.

Nov. 16: *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?

- 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 Jürgen von Hagen. 2000. "Monetary Union and Fiscal Federalism," Policy Working Paper B01, Center for European Integration Studies, Bonn.
- Dahlberg, Matz and Eva Johansson. 2000. "On the Vote-Purchasing Behavior of Incumbent Governments," Working paper, Uppsala University.
- Gibson, Edward, Ernesto Calvo, and Tulia Falleti. 1999. "Reallocation Federalism: Overrepresentation and Public Spending in the Western Hemisphere," Working Paper, Northwestern University.
- 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).

Nov. 30: *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.
- Tommasi, Mariano and Federico Weinschelbaum, “A Principal-Agent Building block for the Study of Decentralization and Integration,” Unpublished paper, Universidad de San Andres (recommended).

Dec. 7: *Why Stay Together in a Global Economy? Theories of Secession 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). 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? Should Scotland remain in the United Kingdom?

- 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. 1998. “The Politicization of Cultural and Economic Difference: A Return to the Theory of Regional Autonomy Movements,” Paper prepared for the Annual Meeting of the American Political Science Association.
- Garrett, Geoffrey and Jonathan Rodden. 2000. “Globalization and Decentralization,” Paper prepared for the Annual Meeting of the Midwest Political Science Association.