

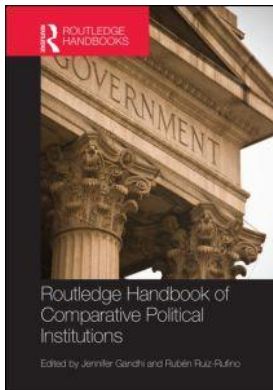
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FEDERALISM

Pablo Beramendi and Sandra León

The failure of the European Union to offer an institutional response to the sovereign debt crisis, the growing challenge in Catalonia to the existing design of the Spanish state, or, in a different context, the inability to craft a stable framework for co-existence of different identities in Iraq, all relate to the question of the virtues (and vices) of different forms of federalism. The evolving geography of political conflict and contestation in the post-Cold War world is rekindling academic interest in the subject. This chapter begins by reviewing basic conceptual issues. We then turn to discuss the origins of federalism and its implications for the functioning of democracy and markets. Finally, we close the chapter by briefly addressing the dynamic aspects of federalism as an incomplete contract and its implications for the question of institutional stability.

Conceptual issues: the nature of federalism

Riker characterized federalism as “a political organization in which the activities of government are divided between regional governments and a central government in such a way that each kind of government has some activities on which it makes final decisions” (Riker 1975: 101). A formal statement in the constitution and the existence of a strong judicial review system typically guarantee the autonomy of these two levels of government. Moreover, both the center and the regions have their own fiscal bases and are directly accountable through elections. As a result, central governments in federations (as opposed to confederations) enjoy a much stronger institutional position vis-à-vis subnational governments, and must find ways, jointly with subnational units, to manage their political and economic interaction effectively.

The comparative politics of federalism has come a long way in understanding the nature of this interaction between federal and state governments in political unions. This required abandoning the notion that federal and unitary states constitute uniform categories. The gradual opening to federal experiences beyond the U.S. case led to the recognition of the multidimensional character of federal structures (Stepan 1999). Not surprisingly, a more accurate description of federal realities came at the price of a less precise definition of the essential qualities of the federal model. Certainly, a strict definition of federalism based on one of its most defining features—the representation of regional interests in the federal legislature—would leave Canada, one of the classic federations, out of the federal sample, as the Canadian senate has no capacity

to shape federal decision-making (Rodden 2004). This example illustrates that characterizing federal credentials requires subtler accounts of relevant institutional features that might not necessarily be identified in the federal constitution. Delving into variation in constitutional and non-constitutional institutions across federations is not only required for the purpose of achieving more precise descriptions of federal realities, but, as we will show in the remainder of the chapter, it is crucial to provide a better understanding of the consequences and evolution of federalism.

Federations exhibit significant differences in terms of both the set of rules that regulate the interaction between levels of government, such as judicial review or the representation of regional interest in the federal legislature, and the specific decentralization agreements that define the distribution of powers between the center and the subnational units. The former institutions have a more resilient nature, as they are most likely identified in the constitution and therefore are less amenable to change over time, whereas the distribution of fiscal and policy authority between levels of government is more likely to experience variation according to changes in governments' preferences or relative bargaining power. Addressing a detailed description of institutional variation across federations is beyond the purpose (and length) of this chapter, so in the next paragraphs we will focus on two of the most important institutions that mediate the interaction between the center and the units, namely the representation of regional interests in federal decision-making and the structure of the party system and electoral competition. In addition, we will present some indicators on the distribution of policy and fiscal authority and discuss along the way current improvements as well as unresolved debates on how to measure variation in institutional design across federations.

Federal countries exhibit enormous variation in the way regional interests are represented in the federal legislature, both in the way upper chamber's representatives are elected and in its relative power to reshape majorities in the lower chamber (Elazar 1991; Watts 2008). In some countries representatives are directly elected from territorial districts (Brazil, the United States), whereas in others they are appointed by regional incumbents (Germany, Austria), the prime minister (Canada) or national legislators (India and Austria). The way delegates are elected may have an impact on how regional electorates are represented in the federal legislature: direct election by the territory's population may facilitate direct representation of local preferences, whereas indirect appointment paves the way for a stronger role of national political parties in mediating the representation of regional constituencies.

The capacity of subnational units to shape the decision-making process of the federal government ranges from the absolute veto power of the upper houses in the United States and Switzerland and the more limited veto in Germany or Belgium (veto on some federal legislation), to the virtually powerless upper chambers in Canada, India, or Spain. In federations with weak upper chambers, the representation of regional interests in the federal arena is more likely to be channeled through negotiations between the federal and regional executives (Watts 2008). In Canada and Spain, for instance, the opportunity of regional governments to shape federal decision-making takes place in a variety of more or less formal policy-specific multilateral bargaining bodies (León and Ferrín Pereira 2011). Political parties play a crucial role in greasing the wheels of intergovernmental negotiation in those bodies, particularly when the party system is highly integrated and strong, disciplined national political parties facilitate cooperation between federal and regional chief executives that share party affiliation.

The relevance of the party system goes well beyond its role in channeling intergovernmental relations, and was defined by William Riker as the most important dimension to understand cross-country variation in the structure of federalism (Riker 1964). The degree of integration of the party system and partisan harmony (the number of regional chief executives sharing party

affiliation with the federal chief executive; see Riker and Schaps 1957) have long been used as proxies of the degree of centralization of federations, as these measures convey information about the ability of the federal government to “overawe” subnational units. More recently, scholars have continued to develop subtler characterizations of patterns of political competition in federations by exploring the internal organization of parties and the degree of interdependence between the regional and federal electoral arenas. Variables such as the dependence of local politicians on central government party officials for nomination, finance, or career advancement define vertical lines of authority and accountability within parties, which appear to favor subnational politicians in federations like Brazil and, less consistently, in Argentina, whereas it favors central party officials in Mexico (Eaton 2004; Montero and Samuels 2004; Thorlakson 2009; Willis *et al.* 2001).

Another dimension of variation across federal countries concerns the distribution of policy and fiscal authority between the center and the subnational units. The most defining feature of policy decentralization in federations is the predominance of shared authority between different levels of government (see Henderson’s *decentralization index*¹; Watts 2003). This means that the widespread move towards decentralization in the last decades (Arzaghi and Henderson 2005; Dillinguer 1994) has mainly consisted of the establishment of joint policy authority between the center and the units (Rodden 2006).

Certainly, the neat distribution of powers envisaged in *The Federalist Papers* is a far cry from the highly intertwined division of governmental authority in modern federal states. There are, however, some differences across federations in the extent of overlapping jurisdictions. In Canada, Australia, and the United States, executive and legislative jurisdictions tend to coincide at one level of government, which results in low coordination requirements in policy-making. In Germany, Austria, or Switzerland state and provincial governments hold executive authority over policy areas that are legislated at the federal level (Watts 2003). This involves a more intertwined distribution of executive and legislative authority that allows for further flexibility in policymaking, but at the cost of lower clarity of responsibilities.

Finally, the most controversial issue in the distribution of authority between the center and the subnational units relates to fiscal powers, as authority over revenues and expenditures represents the nuts and bolts of subnational autonomy. High levels of policy decentralization may involve limited subnational autonomy if decisions about how money is raised, distributed, and spent remain at the central level. Measuring levels of fiscal decentralization across federations has traditionally been a challenging task for scholars working in the area, mostly due to lack of comparable data on subnational revenue autonomy. Data on expenditure decentralization drawn from the IMF’s *Government Finance Statistics* (share of state and local expenditures over total government expenditure) has been often used as a measure of fiscal decentralization. However, expenditure decentralization fails to capture the extent to which subnational governments possess full autonomy over subnational revenues. As a result, it tends to overestimate overall levels of fiscal decentralization and overlooks significant variation in subnational fiscal autonomy across federal countries.

Recent contributions in measuring subnational fiscal autonomy have succeeded in providing a more refined portrayal of variation in fiscal decentralization across federations (Rodden 2004; Stegarescu 2005). When it comes to levels of subnational revenue autonomy, the United States, Canada, and Switzerland exhibit the highest levels of fiscal decentralization, whereas the regulatory framework of subnational revenue autonomy is more centralized in Austria, Belgium, and Australia. Future improvements in data collection require additional developments in comparable measures of subnational fiscal autonomy, as well as an extension of the data beyond the OECD sample (see [Figure 15.1](#)).

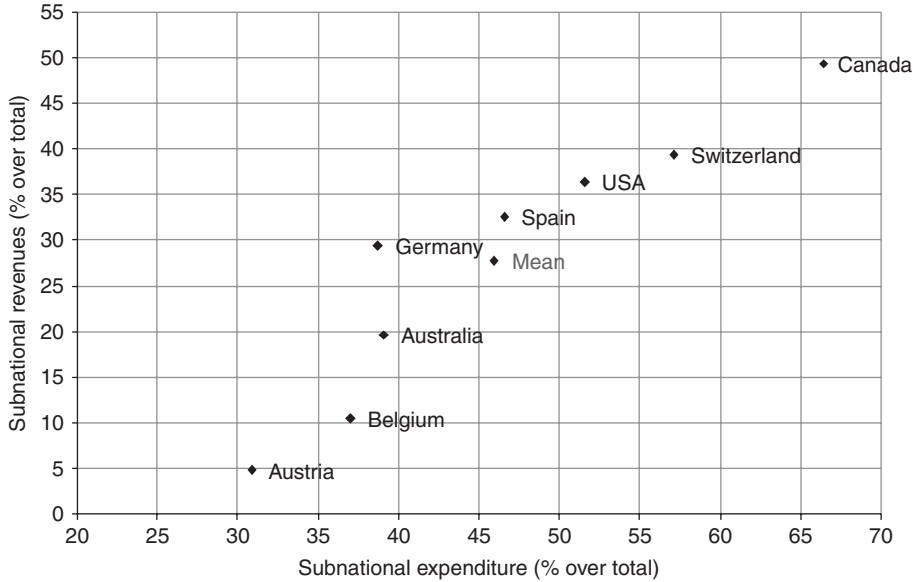


Figure 15.1 Subnational tax revenues and expenditures (% over total), 2011

Source: Government at a Glance 2013 (OECD) and OECD National Accounts Statistics Canada (2010). Source for USA: www.usgovernmentspending.com

To conclude, federations exhibit significant differences both in terms of the institutions and procedures that regulate the interaction between levels of government and the specific distribution of powers between the center and the subnational units. How to narrow this multidimensional variation down into a comparable index of decentralization has long remained a methodological challenge barely addressed by empirical scholars (Arzaghi and Henderson 2005). The most important recent contribution in the area has been the publication by Hooghe, Marks and Schakel (2010) of a Regional Authority Index that measures the authority of regional governments along eight dimensions in 42 democracies or quasi-democracies over the 1950–2006 period. The Regional Authority Index is formed by two compounded indicators, one of *self-rule*, which measures the authority exercised by a regional government over those who live in the region, and another of *shared rule*, an index that measures the authority exercised by a regional government to its representatives in the country as a whole.² Notwithstanding the significant contribution of this dataset to the empirical measurement of the constitutional and non-constitutional aspects of decentralization across countries, there is room for the field to produce a more nuanced account of fiscal arrangements across different forms of decentralization.

The origins of federalism revisited: external pressures, domestic trade-offs, and institutional designs

Riker’s (1964) *Federalism* provides an inflexion point in the study of the origins and functioning of federalism. Until then, the field had been dominated by largely inductive and apolitical approaches (Filippov 2005). Federalism would emerge as the institutional correlate of a number of cultural, historical, or even ideational features of societies.³ Riker’s breakthrough builds on a distinctive analytical innovation: the “establishment of a federal government must be a rational bargain among politicians” (Riker 1975: 116). Such a bargain is approached by

actors with (1) “a desire [...] to expand their territorial control by peaceful means, usually either to meet an external military or diplomatic threat or to prepare for military or diplomatic aggrandizement”; and (2) “a willingness [...] to give up independence for the sake of the union either because they desire protection from an external threat or because they desire to participate in the potential aggression of the federation” (1975: 114).

The key question is what triggers these bargains, what determines the distribution of winners and losers and, therefore, the stability of the specific institutional solution ultimately adopted. We can distinguish three sets of (non-mutually exclusive) mechanisms speaking to these issues directly: external pressures, domestic trade-offs, and endogenous institutional bargains.

The paramount form of external pressure, as in Riker’s own writings, takes the form of a military or diplomatic threat (Lemco 1991). Forced to pool resources by a common danger, smaller units are forced to cooperate. Empirical research (Panizza 1999; Stepan 1999, 2001; Ziblatt 2006), however, suggests that external military threats do not account for the majority of actual processes of formation of federations. Along with military or geopolitical considerations, economic pressures, such as large scale economic externalities across the members of the federation (Casella and Frey 1992; Casella and Weingast 1995) play an increasingly important role as sources of demand for higher levels of political integration.

Yet, however strong the effect of cross-unit externalities on the demand for integration, political actors must balance the expected efficiency gains from federation against their private distributive considerations. This brings us to a second set of mechanisms associated with trade-offs in the future allocation of resources within the emerging federation (Alesina and Spolaore 2003; Bolton and Roland 1997; Beramendi 2012; Wibbels 2005a; Diaz-Cayeros 2007). In this line of research excessive differences among the constituent members in terms of assets (wealth), dominant type of economic activity (extraction versus production, mobile versus non mobile), and income distribution foster fundamental distributive trade-offs that jeopardize the feasibility of the union. The trade-offs are both in terms of net contributions to the common pool as well as in terms of political autonomy: the current delegation of power may come to haunt members in future contention over power or the distribution of assets.

The core of the matter lies in the fact that any constitutional contract is incomplete (Bednar 2009; De Figueiredo and Weingast 2005) and therefore open to opportunistic behavior. Zooming into this problem precisely, Rector (2009) argues that federalism emerges as an institutional solution precisely when states cannot agree on cooperative solutions that could be mutually beneficial due to commitment problems: “Cooperation is risky because it can lead states to invest in assets that are valuable only as long as cooperation lasts” (2009: 31) To the extent that one state invests more in the relationship than the others, its position becomes weaker by virtue of its very investments. At the extreme, fear of excessive exposure deters cooperation. Rector’s theory suggests that federalism is not the result of an agreement based on trust, consensus, and loyalty. Rather, mutual distrust is the very engine of federalism: “federations form when states benefit from cooperation but cooperation requires unequal levels of relationship-specific investments” (2009: 61). In other words, federalism is a cooperative solution that emerges out of distrust. In the presence of potential gains for all parties involved, federalism emerges as a way to manage the commitment problem among uneven partners, as a source of “contrived symmetry.” The management of such symmetry is easier in the presence of some particular features of the organization of power within the federation: Integrated party systems monitor the potential of local elites to deviate from previous contracts (Filippov, Ordeshook, and Shvetsova 2004; Diaz-Cayeros 2007).⁴ And along with the party system, a set of complementary institutions such as constitutional safeguards and the judiciary (Bednar 2009, 2013; Bednar *et al.* 2001), help keep at bay different forms of opportunism. The role of these factors becomes

particularly prominent when analyzing the political and economic consequences of federalism, to which we turn now.

Varieties of federalism and their effects

The democratic and efficiency promises of federalism

The study of federalism was initially anchored in the analysis of the design of constitutions, a legal approach that mostly consisted of descriptive accounts of case studies. The seminal work of Riker (1964), however, prompted the development of an extensive comparative literature with larger analytical grounds and more realistic accounts of politics and institutions. Along the way, normative concerns associated with the optimal design of federal institutions gradually gave way to a more positivist approach to the workings of federations, focusing on the tension between the promises raised by federalism and its actual political and economic consequences (Weingast 2014; Weingast 2009).

Nowadays, the cumulative empirical and theoretical research developed by the comparative literature on federalism tempers the initial enthusiasm over the democratic and efficiency promises of federalism. As we discussed earlier, the actual operation of federations is quite distant from the stylized models of federalism that assume dual accountability and a clear-cut division of authority between levels of government. Indeed, the gap between the ideal design of federalism and the complex and multidimensional nature of federations looms large in explaining why the old expectations of federalism have turned out to be a mere *federal illusion* (Beramendi 2007).

Federalism has shown up time and again as a solution to a variety of institutional, political, and economic problems. However, the cumulative body of theoretical and empirical research about its consequences has balanced the promises of federalism with more realistic accounts about its perils. The existing literature in the area shows that the actual political and economic consequences of federalism are complex and multidimensional and highly contingent upon the specific design of federal institutions as well as economic and social contextual factors. Certainly, the history of the comparative politics of federalism during the last decades has consisted in the rediscovery of these complexities as part of a research agenda aimed at articulating a general theory of federal performance. In the remainder of the section we will review the main theoretical and empirical contributions of this literature, emphasizing the extent to which these works depart from the old promises of federalism.

Federalism and democracy

The oldest promise of federalism is the democratic one. Federalism has been widely considered as an institutional solution to enhance accountability and the control of governments. This promise rests on the assumption of clear-cut distributions of vertical authority between levels of government, but empirical evidence suggests that the intertwined division of governmental authority in some federations is associated with blurred responsibility attribution (Cutler 2004, 2008; Johns 2011; León 2012; Rudolph 2003a, b), although evidence for the U.S. and the European Union shows that voters distinguish among levels of government (Arceneaux 2006; Hobolt and Tilley 2013). Insofar as incomplete information makes individuals unable to establish a causal link between outcomes and politicians' actions, accountability might be undermined. These caveats are not new and were already stressed long ago by Alexander Hamilton in *The Federalist Papers*.⁵ A recent strand of the literature on economic voting has provided evidence of a weaker relationship between economic performance and support for the national

incumbent in federal states (Anderson 2006b, 2009). So far research in the area has been predominantly case-specific, mainly due to the lack of comparable cross-country data on attributions of responsibility. As a result, there is still much to be learned about how different federal designs affect clarity of responsibility and whether this in turn has an impact in variation across federal countries in performance voting.

The presupposed advantages of decentralized government over accountability are clearly undermined when the electoral fates of subnational politicians are shown to be dependent on variables exogenous to subnational performance. The lack of comparable data in the area has resulted in very limited knowledge about whether national dynamics play a larger or smaller role in different federations and what factors account for this variation. Work in this area has been largely built around country cases (mostly the United States) and provides evidence that competition dynamics at the national level and national economic performance have a strong impact in subnational elections.⁶ These findings raise questions about the classic view of “dual accountability” in federations, which presupposes that voters will hold subnational (national) governments accountable for distinctly local (national) responsibilities. The few comparative studies in the field have adopted different empirical strategies to explore the contamination between the federal and regional arenas⁷ (Rodden and Wibbels 2011; Schakel 2013), but their empirical results suggest that the congruence between national and subnational elections decreases in contexts where subnational self-rule is more prominent.

Finally, a growing literature emphasizes the “peace-preserving” qualities of federalism because it allows federal shared-rule to coexist with self-rule (Elazar 1987; Riker 1964). The virtues of federalism in “holding the state together” (Stepan 1999) lie in the provision of “more layers of government and thus more settings for peaceful bargaining” (Bermeo 2002: 99) as well as checks upon the central government’s attempts to dominate ethnic minorities (Gurr 2000; Horowitz 1985). Gurr’s *Minorities at Risk’s* project (2000) offers detailed information on a large set of minority groups in both federal and unitary states, showing that federal regimes facilitate accommodation better than unitary systems. Further evidence on the accommodating success of federalist arrangements is also uncovered in a large comparative analysis across federations coordinated by Amoretti and Bermeo (2004). Yet, many of the less enthusiastic views about the palliative qualities of self-rule come from studies that explore the fate of federations from the communist bloc of Eastern Europe, all of which ended up in disintegration (Bunce 1999; Cornell 2002; Treisman 1997).

The paradox of federalism lies in that the same institutions, policies, and practices that are designed to contain divisions may contribute to perpetuating conflict. Those who take the most optimistic views to task state that federalism contains the seeds of its own disintegration. They argue that federal arrangements divert government functions and resources to territorial subunits that end up strengthening nationalist leaders’ capacity to mobilize for nationalist ends (Roeder 2009; Snyder 2000). Above all, the disintegration dynamics are more likely to unleash in contexts where the internal federal boundaries overlap with ethnic boundaries, strengthening identities and division among political communities (Elazar 1994; Lipset 1959; Watts 2008); or where the existence of regionalist parties spurs on separatist identities and mobilizes groups to engage in secession (Brancati 2006).

In turn, the literature on ethnic conflict regards federalism both as a cure and a curse for state disintegration (Bakke and Wibbels 2006). Evidence based on case studies suggests that the ability of federalism to contain conflict and prevent disintegration is highly contingent upon the specific design of federal institutions (Filippov *et al.* 2004; Hechter 2000; Stepan 2001). However, other works point to the importance of non-institutional factors such as income disparities to account for federal stability. Bakke and Wibbels (2006) find that in contexts with high levels of

interregional inequalities fiscal decentralization increases the likelihood of conflict through its tendency to amplify cross-regional income inequalities. When wealthy regions find that the costs of financing redistribution to poorer regions offset the benefits provided by the undivided state (military security, economies of scale), pressures towards secession increase (Alesina and Spolaore 2003; Sambanis and Milanovic 2011). In turn, in contexts with high regional inequalities, federalism might survive only as long as control over redistribution is decentralized (Boix 2003). Both the Scottish and Catalanian cases illustrate the role of interregional inequalities in fuelling reforms of federal institutions, particularly a redefinition of fiscal tax and revenue powers that grant regions further fiscal autonomy.

Federalism and the market

The federal illusion has two pillars: democracy and markets. Interestingly, the notion that federalism leads to better markets is common intellectual ground for both welfare economists and public choice theorists. For *welfare economists* (Musgrave 1997; Gramlich 1973, 1987; Oates 1972, 1991, 1999; Wildasin 1991), federalism and decentralization facilitate the goal of an optimum allocation of resources by ensuring a better fit between preferences, needs, and policies via informational matching and experimentation. Within this framework, factor mobility operates primarily as a factor of preference revelation for welfare maximizing incumbents.⁸ In turn, for *public choice theorists* (Brennan and Buchanan 1980; Buchanan 1995: 19–27; Inman and Rubinfield 1997: 73–105; Qian and Weingast 1997: 83–92; Weingast 1993: 286–311; 1995: 1–31; Weingast *et al.* 1995: 50–81) federalism enhances markets by containing Leviathan's wasteful appetite. Within this framework, factor mobility operates as a factor constraining government's predatory tendencies. By allowing voters and factors to vote with their feet across jurisdictions, federalism facilitates a better monitoring of incumbents by markets and voters.⁹ Accordingly, less corruption and smaller states facilitate a better functioning of markets (Prud'homme 1995).

A wealth of comparative and empirical research over the last three decades allows academics and practitioners to know better by now (Rodden 2006; Wibbels 2006). Federations and decentralized structures vary widely in the outcomes they generate. The range in outcomes is large. In non-democratic contexts, the removal of a subnational layer of government improves governance by limiting corruption (Malesky *et al.* 2014). Autocracies also use the promotion of local politicians as a mechanism to keep localities under the political control of the center (Landry 2008). In democratic but corrupted and clientelistic societies, capital mobility and federalism not only fail to discipline governments and boost experimentation; they produce worse outcomes by reinforcing a low productivity, high extraction equilibrium (Cai and Treisman 2005). On the contrary, federalism has facilitated sustained economic growth in the USA and Switzerland.

There is no gainsaying that the economic consequences of federalism depend on the interaction between two variables: the specific design of federal institutions and the context in which these institutions actually operate. The specialized literature has identified three distinctive mechanisms governing this interaction: (1) the organization of representation in federations; (2) the specifics of the fiscal constitution; and (3) the dimensionality of the political space and the polarization within dimensions in the federation.

Representation

Representation matters because it determines the balance of power between the center and the units. In centrifugal federations (Beramendi 2012), the center lacks monitoring ability and regions enjoy opportunities to free-ride and abuse the common pool. In centripetal federalism,

by contrast, an overpowered center has incentives to overrule constituent units and extract rents from its privileged position. In centrifugal federations, unruly, vested local interests risk rendering federalism inefficient (Inman and Rubinfeld 1997; Breton 1996; Eichengreen and Von Hagen 1996). In centripetal federations, the effective disappearance of self-rule defeats the very purpose of federalism (De Figueiredo and Weingast 2005; Wibbels 2005a; Rodden 2006). The core issue still remains of how to preserve the autonomy of local elites while limiting their incentives to distort the market at the same time. More generally, the optimal balance of power is a delicate, multidimensional problem (Bednar 2005, 2009) where several aspects of the institutional design of political unions play an important role.

On the premise that under any given design actors will set out to maximize the amount of rents they can extract (Inman and Rubinfeld 1997; Cremer and Palfrey 1999, 2000; Dixit and Londregan 1998), the representation of regional interests in the national arena plays a fundamental role in the working of federations (Wibbels 2005a, Rodden 2006, Beramendi 2012). Representation ultimately reflects the interplay between formal institutions and the organization of the party system.

Given that policies are made at the national level, market regulations, fiscal discipline, and income redistribution are in part explained by the ability of regions to use their formal representation in national institutions to obstruct or shape reforms. Wherever upper chambers play an important role in defining economic outcomes, the nature and scope of reform reflects the bargaining power of the regional coalitions for and against specific policy changes.¹⁰ A strongly malapportioned senate facilitates veto power by specific regions and increases their ability to extract resources. This leverage, however, can be offset by the organization of the party system. Party systems matter because of the career concerns of politicians and because they help overcome time inconsistency problems between elites across levels of government. Weak party systems create uncertainty about earlier promises by either the state or federal government.¹¹ Strong party systems have the organizational ability to impose sanctions on regional politicians violating national agreements and therefore reduce their incentives to behave irresponsibly, either fiscally or politically. Put differently, strong, integrated party systems tie together the fate of political elites across levels of government and generate strong electoral externalities (Rodden and Wibbels 2002, 2011), ultimately rendering the federal contract more stable.

Fiscal constitution

In addition to the organization of representation, the second feature mediating the economic outcomes of federations concerns the degree of fiscal accountability and autonomy granted by the constitution. Fiscal accountability refers to the extent to which subnational units actually internalize the consequences of their economic behavior. Fiscal autonomy implies that subnational governments rely more on their own revenues and less from transfers from the federal government. Yet, the reverse is not necessarily true. Fiscal autonomy does not always imply high levels of fiscal accountability. That depends on how hard the budget constraint is.

Given soft budget constraints, fiscally autonomous regions incur large debts, thereby shifting the costs of fiscally irresponsible policies to other units in the federation. As a result, if the central government bails out subnational ones from their financial obligations, macroeconomic and distributive outcomes tend to worsen as subnational units become more transfer dependent. To this effect, regional transfer dependency is associated with a higher demand for bailouts (Rodden 2006), resistance to market reforms (Wibbels 2003), and non-cooperative relationships between levels of government and their constituencies. The logic behind poor economic outcomes follows from political incentives as shaped by the existing institutional design.

By introducing competition between several policy suppliers, federalism sets the stage for central and subnational governments to behave non-cooperatively. Incumbents at both levels of government seek political credit for the goods and services provided to citizens while they aim to minimize the costs incurred in satisfying citizens' demands (Migué 1997; Volden 2004, 2005; Inman and Rubinfeld 1997). They also seek to minimize the electoral impact of unpopular policy reforms. As a result, subnational governments often incur high levels of debt to be paid by the rest of the federation through a federal bailout. More generally, federations often confront a moral hazard problem: local authorities take advantage of federal risk-sharing schemes to enact policies that increase local risks. Symmetrically, by decentralizing social programs without transferring the necessary resources, central governments manage to off-load to regional incumbents the political costs of retrenching publicly provided social welfare. Soft budget constraints facilitate and reinforce these dynamics.

By contrast, given hard budget constraints, fiscal autonomy leads to better economic and social outcomes by reducing capture via transfer dependency, facilitating experimentation, and ensuring a better fit between preferences and policies at the local level (Qian and Weingast 1997; Bardhan and Mookherjee 2005).¹² Fiscally autonomous subnational units reduce aggregate deficits and inflation rates and facilitate sustained economic growth. More fiscal autonomy shapes the extent to which subnational governments internalize the benefits of their economic progress, creating incentives for subnational incumbents to create a market preserving environment. Stein's (1999) analysis of Latin American federations illustrates the logic: decentralization tends to worsen economic outcomes where vertical imbalance is high, transfers are discretionary, and the degree of borrowing autonomy by subnational governments is high. More generally, both the size of government and the macroeconomic effects of expenditure decentralization are shown to be contingent on the levels of fiscal autonomy (Rodden 2006; Rodden and Wibbels 2002).

To sum up, well-defined allocations of fiscal powers facilitate both autonomy and accountability, leading to better efficiency and distributive outcomes. By contrast, convoluted, opaque, ambiguous, ever changing intergovernmental fiscal arrangements provide a natural breeding ground for political and economic opportunism (León 2010).

Dimensionality

Federations are by definition two dimensional political spaces: citizens' preferences are weighted against those of territories. And, as discussed, the system of representation reflects the balance. Beyond this basic fact, however, federations vary in the degree of complexity of their political space and such complexity is an important mediator of the feasibility of self-enforcing, stable agreements. The logic is straightforward: as the dimensionality increases, and the intensity of preferences of specific groups over one particular issue makes them less flexible in negotiations, the room for either stable political arrangements and/or the sort of fiscal and representative arrangements that facilitate efficient and fair market outcomes shrinks. Ultimately, once the degree of preference dimensionality and heterogeneity passes a threshold, federalism is no longer a viable institutional solution, and any attempt to impose it, may in fact backfire.

There are many sources fuelling preference heterogeneity within federations. A relatively well understood one concerns the degree of asset specificity across regional economies. Asset specificity conditions the effectiveness of the constraints typically associated with labor and capital mobility as the degree of factor mobility decreases with the degree of specialization of the regional economy (Boix 2003; Beramendi 2012). In a specialized, asset specific economy, human capital and skills are tied to the regional labor market. In addition, capital is less responsive to tax

advantages and more sensitive to the fit between its production needs and the characteristics of the labor force and educational system. As a result, incumbents in richly endowed units may be less constrained by the potential externalities of decisions adopted in other jurisdictions and more constrained by the likely formation of cross-class regional coalitions. Moreover, heterogeneity among units alters the incentives of the poorly endowed units. Since capital is likely to flow from poor to rich regions, they abandon any attempt to promote economic efficiency through policy. As a result, capital mobility facilitates rather than disciplines the ability of poor units' incumbents to engage in ineffective public policy (Cai and Treisman 2005). This introduces a different dimension that cuts across other aspects of the organization of federations and their economic implications.

A second, and more prominent, source of preference heterogeneity concerns ethnic, religious, or national identity differences among the members of the federation. As we discussed earlier, federalism emerges as a source of artificial symmetry among uneven partners (Rector 2009), and the management of such symmetry is more difficult where the borders of the political units are drawn along ethnic or religious lines.¹³ The room for stable arrangements that facilitate efficient economic outcomes declines with heterogeneity in preferences about basic political and fiscal arrangements, which are in turn proportional to cross-regional variation in ethnicity, religion, or national identity. Asymmetric arrangements for regions with strong identities such as the existing ones in Quebec or in the Basque Country often offer the only viable possibility for preventing conflict. However, asymmetric federalism may not be a sufficient condition to appease centrifugal tensions, which may crucially depend on the existence of identity-based and regional parties that dominate the representation of territorial interests (Brancati 2004). Interregional economic inequalities may remain dormant until regional political entrepreneurs succeed in exploiting them by constructing identities and/or activating ethnic or identity issues in the electoral arena. Decentralization of political power and resources to territorial subunits may actually contribute to strengthen regionalists' capacity to reinforce those identities (Brancati 2006), which confers federal structures with a "double-edge" nature in the execution of stable political and economic agreements (Erk and Anderson 2009).

Concluding remarks: federalism, distribution, and stability

A precise definition of the essential qualities of the federal model has become a difficult task given the enormous institutional variation associated with federal realities. However, all federal countries are grounded in the same delicate balance between unity and autonomy and, in turn, in a fundamental tension between two devils: a too strong center that "overawes" subnational units and the potential abuses by opportunistic subnational elites. The stability of federal institutions cannot be enforced by the constitutional contract due to its incomplete nature, so a better understanding of the dynamic aspects of federalism and their implications for the question of institutional stability requires focusing on other mechanisms, namely the specific design of federal institutions and the context in which these institutions operate.

The secessionist pressures in Catalonia or the failure of the European Union in dealing with the sovereign debt crisis illustrate the importance of the specific design of representation and fiscal arrangements and its interaction with contextual factors for understanding the self-enforcing dynamics of federal institutions. These two experiences show the nature of federalism as an institutional form that evolves endogenously by virtue of its own distributional effects (Beramendi 2012). Its success as an institutional engine for stability depends critically on securing an institutional design that prevents defection across levels of government by affording everyone input in the political process and anticipating, to the extent possible, future distributive struggles.

Centrifugal representation in the European Union explains the design of a monetary union without fiscal integration, which preserved territorial inequalities. The asymmetric impact across member states of the sovereign debt crisis triggered a territorial distributive conflict and increased the heterogeneity of preferences about the design of distributive mechanisms within the Economic Monetary Union. Increasing polarization between member states' preferences about the potential reform of distributive institutions (more or less Europe?) has raised speculations about the potential break-up of the Eurozone. However, the diversity of preferences among member states seems too strong to allow for further fiscal integration in the future.

In Spain, centripetal representation at the time of the constitutional arrangements in 1978 explains the centralist design of redistributive policies (social security). The distributional consequences of this initial fiscal pact as well as the constitutional fiscal privileges granted to the Basque Country and Navarre explain Catalan elites' continuous demands for a reform of fiscal arrangements. Catalan representatives have demanded the same levels of fiscal autonomy as in the Basque Country and Navarre, arguing that the level of redistribution of the system is excessive. These claims have triggered different reforms of federal fiscal arrangements during the last decades and, in turn, have increased the distributive conflict about the allocation of resources among regions. A crucial factor in fuelling heterogeneous preferences has been the presence of dominant nationalist parties both at the regional and national level and the resulting centrifugal push of political competition. The increasing polarization of the preferences over political and fiscal federal arrangements among regions is currently challenging the territorial organization of the Spanish state, as a majority of Catalan elites regard secessionism—and not reforms of fiscal federalism—as the only viable solution of the conflict.

Notes

- 1 www.econ.brown.edu/faculty/henderson/papers.html
- 2 Further information on the project and data can be found at www.unc.edu/~gwmrks/data_ra.php
- 3 For example see Deutsch (1957) on social and communication conditions for federalism to emerge as a “security community.” See also Wheare (1946) and Bowie and Friedrich (1954).
- 4 In turn, the link between parties and the functioning of institutions tends to be reinforced over time. Focusing on the reverse causal path, Chhibber and Kollman (2004) examine the experiences of Canada, India, the United States, and the United Kingdom to argue that fiscal and administrative centralization is an important factor driving the centralization of the party system.
- 5 “It often becomes impossible, amidst mutual accusations, to determine on whom the blame or the punishment of a pernicious measure, or series of pernicious measures, ought really to fall. It is shifted from one to another with so much dexterity, and under such plausible appearances, that the public opinion is left in suspense about the real author” (Alexander Hamilton, *The Federalist Papers*, n. 70).
- 6 Some studies show that national conditions matter in explaining electoral results in regional elections (Anderson 2006a, b; Atkeson and Partin 1995; Carsey and Wright 1998; Gélinau and Bélanger 2005; Gélinau and Remmer 2006; Hansen 1999; Niemi *et al.* 1995; Partin 1995; Remmer and Gélinau 2003). Others have found that the electoral support of regional incumbents depends on regional economic conditions (Lowry *et al.* 1998; Partin 1995; Squire and Fastnow 1994).
- 7 Rodden and Wibbels (2011) measure electoral externalities between national and regional elections as the correlation between vote-shares in federal and regional elections; whereas Schakel (2013), drawing from recent works on territorial politics in Europe (Jeffery and Hough 2009), develops a *dissimilarity index* that measures congruence between national and regional elections.
- 8 Provided that the demand for local public services is income elastic, that these services are financed by income taxes (Oates 1972, 1991) and that there is perfect mobility, Tiebout's (1956) model predicts that communities become homogeneous in income and heterogeneous in capacities. For a critical evaluation of the benefits and shortcomings of these assumptions, see Panizza (1999).

- 9 The relationship between mobility and redistribution in federal systems is a field of its own. For a more detailed treatment on the subject, see Peterson and Rom (1990) and Epple and Romer (2001).
- 10 There is a wealth of empirical results on this subject. Gibson, Calvo, and Falleti (2004) show that if poor, underpopulated units are overrepresented in the upper chambers, federalism severely constrains macro-economic efficiency. Finally, Wibbels (2003) finds that influential and malapportioned senates facilitate the emergence of pro-bailout coalitions.
- 11 Weak party systems correlate quite closely with low levels of development and clientelism (Kitschelt and Wilkinson 2007) which in turn shape the economic consequences of political exchanges. If the principal (citizens) is poor, uneducated, or socialized in a polity where the rule of law has given into private exchanges between patrons and clients, agents (i.e., political elites) likely hold office with the purpose of maximizing their clients' rents, as well as their own. In these contexts, civic virtues lag behind in society's preeminent values. As a result, the dynamics of local politics disrupt rather than facilitate the efficient working of the economy (Wibbels 2005a; Treisman 2007). In contrast, a better educated principal, coupled with a generally endorsed set of principles guiding public life and a consolidated legal system, creates a very different interaction between principal and agents. Electorates are more likely to punish outright rent extractions by public officials and reward good governance and economic performance. Incumbents will seek to remain in office by maximizing the satisfaction of a majority of the members of their respective *demoi*.
- 12 The effectiveness of hard budget constraints is not straightforward. Legal provisions not to bail out subnational governments may not be enacted, giving way to a strategic interaction between the center and the units where the identification of bailout expectations becomes crucial. On the difficulty of empirically identifying bailout expectations and their implications for fiscal outcomes in federations see Rodden (2006).
- 13 This is the most common scenario in multinational federations, as one of the reasons why federalism is advocated as a "peace-preserving" institutional device is precisely that it grants ethnic minorities with extensive political and financial powers.

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