ON FEDERALISM AND ECONOMIC DEVELOPMENT

Daniel L. Rubinfeld

In Does Federalism Preserve Markets? Jonathan Rodden and Susan Rose-Ackerman ("Rodden/Rose-Ackerman") have written a thoughtful, provocative critique of the new institutional economics approach to economic development espoused by William Riker and by Barry Weingast and his colleagues. Both Weingast and Rodden/Rose-Ackerman are concerned with choosing the government structure that is best able to promote long-term economic development. Weingast's "market-preserving federalism" approach stresses the advantage of decentralized control by subnational governments: By encouraging competition, this control is likely to avoid the adverse consequences of a centralized government's interference with otherwise competitive markets. The tension raised by Weingast is whether a nation-state strong enough to enforce contract and property rights will refrain from making unreasonable demands on some of its constituents. Riker's conception of federalism defines a federal system as: 1) a hierarchy of governments; 2) with each level of government autonomous in its own sphere of authority; and 3) with each government's autonomy guaranteed. Weingast makes further assumptions to support his theoretical perspective: 4) "subnational governments have primary authority over [their] economies"; 5) the national gov-

* Professor of Law and Professor of Economics, University of California, Berkeley, currently on leave as Deputy Assistant Attorney General for Economics with the Antitrust Division of the U.S. Department of Justice. The opinions and observations contained here are a product of my visit to South Africa as part of the World Bank Mission to South Africa on Local Government Finance, under the supervision of Junaid Ahmad, June and November, 1996. Much of the material in Part I is based on this consulting project, while Part II builds on my joint work with Robert Inman. These opinions do not necessarily reflect the views of the South African government or the World Bank.

5 Id. at 53; Weingast, Political Institutions, supra note 3, at 3.
6 See, e.g., Weingast, Political Institutions, supra note 3, at 3.
7 See Weingast, Constitutions, supra note 3, at 287.
8 Riker, supra note 2, at 11.
ernment ensures the mobility of goods and people; 6) there is limited revenue sharing so that governments face real budget constraints; and 7) there is a durable allocation of authority.\(^9\)

Rodden/Rose-Ackerman criticize the Weingast model for its lack of attention to political institutions. In my view these comments are generally well founded. However, unlike Rodden/Rose-Ackerman, I remain reasonably sanguine about the positive benefits that the Weingast structure offers, and I prefer to see the Rodden/Rose-Ackerman article as suggestive of how the Weingast structure can be improved rather than rejected. Perhaps Weingast is overly concerned with the risks of central government intrusion into the affairs of local governments. I believe, however, that an effective federalist system, with an active central authority that encourages economic efficiency and political participation and respects basic individual rights, can promote long term economic growth.

This Commentary is concerned primarily with normative issues.\(^10\) From that perspective, I find the Weingast model surprisingly limited on the supply side, in that it fails to characterize fully the nature of the political structures that would comprise a market-preserving federalist system. Like Rodden/Rose-Ackerman, I find the model insufficiently specified to serve as a base for reliable policy analysis.

My specific Commentary falls into two parts. I begin in Part I with an analysis of a special case: post-apartheid economic development in South Africa. In that context I suggest why a relatively rapid move to a decentralized economy, of the type that the Weingast framework might suggest, may be counter to the interests of long-run economic development. It is, of course, easier to criticize an existing framework than it is to develop a new one. Thus, in Part II, I sketch out the federalism principles that flow from a preferred federalist model that pays more attention to political institutions than does the Weingast model.\(^11\) I hope that the principles that I outline can serve as underpinnings for a more robust framework in which federalist issues relating to economic development can be evaluated.

I. SOME LESSONS FOR SOUTH AFRICAN FEDERALISM

I find the ideal of a decentralized federal system to be more appealing than do Rodden/Rose-Ackerman. For example, I believe as a general rule that

---

9 Montinola, Qian & Weingast, supra note 4, at 55.
10 As a positive device for describing the actual development of federalist economies such as India and China during periods of economic development, the Weingast framework appears to work well.
11 These principles are explicated in greater detail in Robert P. Inman & Daniel L. Rubinfeld, Rethinking Federalism, 11 J. Econ. Persp. (forthcoming Fall 1997) (manuscript on file with the Virginia Law Review Association).
rent-seeking activities are most likely to be limited with locally controlled programs, and that legislative politics in the United States has on the whole been more inefficient at the national level than on the state and/or local level. Further, I believe that the separate values of political participation are ideally best enjoyed at the local level.

A strong predisposition towards decentralization characterized my perspective as I began to consider the prospects for the introduction of a new federalist system in South Africa. Having been deeply immersed in that project for quite some time, however, I have become convinced first hand that many of the Rodden/Rose-Ackerman criticisms of the limitations of the Weingast framework have validity. The fact is that the supply side—the characterization of political institutions—is a crucial consideration in evaluating a federal system. These institutions must be seen as real constraints on the ability of a federalist system to support economic development. In some cases, and South Africa may be one, the move towards decentralization should be substantially slowed, if not limited, in light of supply side issues.\(^2\)

In restructuring its federalist system, the South African government has given the objective of long term economic growth substantial prominence. At the same time, however, the government wishes to achieve certain essential redistributive goals, including the provision of minimum levels of basic public services such as sewage, water, electricity, and education. The new constitution in South Africa has created nine new provinces,\(^3\) each of which is to have substantial control over a number of public expenditure programs.\(^4\) There is little doubt that South Africa was a highly centralized federalist system under apartheid, and there is no question that substantial decentralization will occur over the next several years.\(^5\) How much decentralization and whether subnational governments will be given autonomous authority in transition and in the long run remain open issues. In fact, the question of which functions will be included within the provincial umbrella is not entirely clear, nor is the extent to which provincial budgets for both current and capital expenditure programs will be financed by taxes or by grants from the central government. Also unsettled is what functionary role metropolitan and submetropolitan governments should play.

\(^2\) For further background on the South African federalist system, see Jeffrey Petchey & Daniel Rubinfeld, Inter-governamental Transfers and Local Governments in South Africa (Nov. 20, 1996) (unpublished manuscript, on file with the Virginia Law Review Association).

\(^3\) S. Afr. Const. ch. 6, § 103(1).

\(^4\) See, e.g., S. Afr. Const. ch. 6, § 120 (discussing definition and passage of “Money Bills” in provincial legislatures).

Is a market-preserving policy of the type prescribed by Weingast possible within South Africa? For such a federalist system to develop, a number of significant reforms would be required. Currently the central government controls all tax instruments except property taxes, use taxes, and certain relatively insignificant gambling and motor vehicles fees; as reforms continue, provinces and perhaps local governments would require substantial taxing authority. Many local governments currently claim that they are facing bankruptcy; these governments would need sufficient funds or taxing authority to manage their own financial affairs prudently. Moreover, many citizens are refusing to pay for electricity and other local services (in both low-income black areas and high-income white areas), thus, renewed political support for the federalist system would need to be encouraged. The central government allocates at least two percent of its gross domestic product to lower levels of government through grants; additional taxing authority would allow this number to be reduced. Finally, and perhaps especially significantly, many local jurisdictions have made it clear that their goals for public sector provision are not consistent with the long-run social goals of the South African government; these varying goals would need to be reconciled before a market-preserving federal system could develop.

Does it make sense, given these problems, to adhere to the four added assumptions of Weingast's market-preserving federalism? I believe not. At least in the short run, subnational governments are not likely to be effective managers of their local economies, as required by Assumption Four. Provinces do not have control over the macro instruments to manage their economies, nor do they currently have needed regulatory experience.

Assumption Five for a market-preserving policy requires the mobility of goods and factors across subgovernment jurisdictions. While there may be substantial mobility of goods and capital across jurisdictions in South Africa, mobility of labor among provinces is substantially limited by cultural preferences, limited incomes, and some of the remaining rigidities associated with the apartheid regime. Moreover, the Rodden/Rose-Ackerman arguments that suggest the limits of competition's ability to restrict rent-seeking politicians are well taken. As a result, it is unlikely that competition among the nine provinces will be sufficient to generate the efficiencies that one would expect from the decentralized competitive ideal.

It seems clear that further decentralization to metropolitan and local governments is required, but it also seems unlikely that the resources available to those governments would be sufficient in many cases to fund the redistribu-

---

16 Petchey & Rubinfeld, supra note 12, at 13.
17 See id. at 9.
18 Id. at 21.
19 See supra note 9 and accompanying text.
tive programs that are essential to achieve the national goals described earlier. The problem of interjurisdictional inequality raised by Rodden/Rose-Ackerman is particularly pertinent in South Africa. Therefore, contrary to Assumptions Four and Six of the Weingast framework, a program of substantial intergovernmental revenue sharing will be required. In Assumption Six, Weingast suggests that reliance on intergovernmental grants creates a soft-budget constraint that could lead to inefficient local budgeting. I believe, however, that a consistent, predictable system of revenue sharing, which is insensitive to political bargaining between local and central governments, is consistent with a hard budget constraint. Further, an effectively designed revenue sharing system, one which distributes funds to places as well as people, can achieve a number of important national political goals and encourage economic growth. Consistent with the comments of Rodden/Rose-Ackerman, the market-preserving federalist system is unable to achieve the redistributive goals that are essential for a successful South African economic experiment.

There are four useful, analytically distinct policy instruments which can be effective in distributing funds from the central government to the provinces and from the provinces to lower levels of government: 1) Unconditional revenue sharing aid can be designed to give lower level governments basic support for the provision of public services (removing some of the tax base inequities that arose out of the apartheid system); 2) Conditional matching aid can be designed to provide additional aid for each additional rand of municipal spending on targeted public services and/or public infrastructure investment; 3) Categorical aid can be designed to allow lower level governments to provide specific targeted public services up to certain prescribed basic levels; and 4) Capacity equalizing aid can be designed to give provinces and municipalities access to equal taxing capacity when providing public services at prescribed tax rates or choosing their own tax rates.

Assumption Six also suggests implicitly that local governments should have sufficient taxing authority to balance their own budgets. The difficulty is that with their current authority, many jurisdictions have been unable to collect adequate revenues from taxpayers, with a particular problem being payments for basic utility services. This reflects 1) a continuation of the practice of not paying taxes as part of non-whites' concerted opposition to the apartheid-era government in black local areas, despite the strong urging by the central government of a change in policy; and 2) a decision by many whites in certain high-income localities to protest the rapid increase in local taxes. A second-best transition policy may be required. Such a policy would rely more heavily on national taxes and revenue sharing to finance local public services. An

---

20 Rodden & Rose-Ackerman, supra note 1, at 1555-62.
21 Petchey & Rubinfeld, supra note 12, at 9.
appropriately designed system of indirect taxes (which are less visible than direct taxes to taxpayers) may be the most effective device to achieve the government's redistributive goals and to maintain the broad political support that is required for long term economic growth.

Assumption Seven of the Weingast model requires a durable allocation of authority and responsibility, and for good reason given a goal of long term stability and growth. In South Africa, however, a durable allocation approach is unlikely to be successful, simply because the transition policies for the federalist system may be quite distinct from the long term policies. There are a number of reasons for this. First, while the devolution of powers to the provinces is important in the long run, such devolution must be limited in transition since provinces currently have little taxing authority. Second, an ideal revenue sharing system would be sufficiently flexible to be adjusted over time as subnational economic conditions change. In the short run, however, such flexibility may not be desirable since many of those who will be administering the revenue-sharing programs are those who served the apartheid regime, and who may attempt to undermine the redistributive goals of the new regime. Accordingly, the central government must, in my view, play an important and an active role in setting the rules of the game to be played by subnational governments.

Finally, I see a move towards the privatization of many nationalized industries as consistent with the goals of market-preserving federalism. In South Africa, however, as in other countries, such privatization must be (and is being) driven by the central authority that administers the nationalized businesses. Until the transition to a privatized economy is well along the way, the decentralization of many governmental functions and powers may be undesirable.

In summary, I have suggested in the case of South Africa why a fully decentralized federal system may not be the best foundation from which to stimulate long term economic growth. What would an ideal federal system look like? In the Part that follows, I outline and discuss some of the normative federal principles that could provide that foundation.

II. NORMATIVE PRINCIPLES FOR A FEDERALIST SYSTEM

If a federalist structure is to support economic development and be non-authoritarian, it should 1) encourage the efficient allocation of national resources; 2) foster political participation and a sense of the democratic community; and 3) protect basic liberties and freedoms. A discussion of the three principles of federalism that follow from these goals can serve as the basis for a sound economic and political system that can achieve them.\textsuperscript{22}

\textsuperscript{22} See Inman & Rubinfeld, supra note 11 (discussing further the different principles of federalism).
A. Economic Federalism

The principle of economic federalism prefers the most decentralized structure of government capable of internalizing all economic externalities. Under this traditional economic view, the central government should bear responsibility for those public activities distinguished by significant externalities, while leaving local governments responsible for those public activities for which spatial spillovers are limited or absent. The number of local governments should be chosen so that all economies-of-scale in the provision of public services to households are just exhausted.

Under the principle of economic federalism, the central government provides those public services which approximate pure public goods and is responsible for correcting (through regulations, taxes, or subsidies) those inefficiencies arising from production or consumption externalities across jurisdictions. This view also recognizes that when there are significant intercommunity interdependencies, competition among small governments may result in a race to the bottom and economically inefficient public policies. Economic federalism assigns the representative central government the task of correcting such misallocations.

Market-preserving federalism may be inconsistent with this fundamental economic principle, since the former requires a clear separation with respect to central and local governments, while the latter does not. Faced with this inconsistency, it is my opinion that the interdependencies suggested by the economic principle of federalism are essential. It is common and appropriate for the central government to utilize a system of grants-in-aid to correct inefficiencies resulting from externalities. I understand, of course, that to retain meaningful local control over budgets and to avoid the moral hazard of having local governments view such transfers as blank checks from the central government, such grants should be firmly tied to a publicly reviewed and locally decided tax rate.

The economic federalism principle has had only mixed success as a guide to economic policy. The principle's strength has been to articulate carefully how fiscal competition among decentralized local governments can ensure the efficient provision of public services. Its weakness has been to advocate, by default, the central government as the one institution best able to provide pure public goods and correct interjurisdictional externalities. With our growing understanding of the political realities of how representative legislatures set central government policies, the deference shown by the principle of economic federalism to the central government may be excessive. Weingast and

24 Examples include aid for the U.S. interstate highway system and aid supporting public school lunch programs.
his colleagues therefore deserve credit for developing a simple federalist model that stresses the advantages of decentralization over the disadvantages that may be associated with externalities. Unlike Weingast, however, I believe that consideration also should be given to two additional principles: 1) a principle of cooperative federalism and 2) a principle of democratic or majority-rule federalism.

B. Cooperative Federalism

The principle of cooperative federalism prefers the most decentralized structure of government capable of internalizing all economic externalities, subject to the constraint that all central government policies are agreed to unanimously by the elected representatives from each lower-tier government.\(^{25}\) Like economic federalism, cooperative federalism also embraces the goal of economic efficiency as its central objective and advocates the use of lower-tier governments to provide congestible public services. Cooperative federalism, however, is much less optimistic about the ability of a central government to resolve the inefficiencies which might arise from public good provision and intrajurisdictional fiscal competition. To check potential central government inefficiencies, this principle requires that all central government policies are unanimously approved by the elected representatives from each of the lower-tier governments. Central government political agreements are achieved through bargaining between all affected parties.

Agreements between lower-tier governments require residents living outside the state or local jurisdiction harmed by a local fiscal policy to compensate the residents inside the jurisdiction setting the policy for the benefits they lose when the inefficient policy is distributed. In practice, such compensation is paid through an intercommunity agreement in which jurisdictions raise taxes and pay compensation to their neighboring governments, which in turn return those funds to groups initially favored by the inefficient policy. Under the principle of cooperative federalism, the primary functions of the central government are to encourage and enforce interjurisdictional contracts, which provide pure public goods and correct the failings of lower-tier fiscal competition. There a number of reasons, however, to doubt that interjurisdictional, “Coasian” bargains\(^{26}\) are effective. If the preferences of the


\(^{26}\) The type of bargains contemplated under cooperative federalism is discussed at length in Coase. Id. (explaining that when there are substantial benefits to nonresidents from removing a harmful policy, compensation can be paid to residents so that all individuals are better off); see also Robert C. Ellickson, Public Property Rights: Vicarious Intergovernmental Rights and Liabilities as a Technique for Correcting Intergovernmental Spillovers, in Essays on the Law and Economics of Local Governments 51 (Daniel L. Rubinfeld
participants to the bargain are not common knowledge, there may be a strategic advantage to concealing costs and benefits, enabling a jurisdiction to demand greater compensation than if full information was forthcoming. Further, if many governments are adversely affected by one state's public policy, the affected jurisdictions may understate their gains from reforming the harmful policy. Such free-riding behavior is likely to undo a Coasian bargain, particularly when the number of affected jurisdictions is large.

Enforceability of agreements can also be a problem. In principle, intergovernmental agreements are legally enforceable, but in practice, enforcement requires effective sanctions against a violating party. Arguably the most important, and perhaps least appreciated, source of bargaining failure is the inability of the parties to agree how to divide the economic surplus generated by the bargaining process. Strategic interplay becomes more complicated if the number of bargaining jurisdictions increases beyond two or if the bargain is one of many.

While rejecting any tendency towards centralization that may be implicit in the principle of economic federalism, the principle of cooperative federalism may move too far in the other direction. There are no convincing arguments nor supportive evidence that decentralized, lower-tier governments can solve their collective action problems on their own through unanimous agreements. It is useful, therefore, to consider a third guiding principle of federalism, suggested by the new political economy literature.

C. Democratic (Majority-Rule) Federalism

The principle of democratic federalism prefers the most decentralized structure of government capable of internalizing all economic externalities, subject to the constraint that all central government policies are agreed to by a simple majority of the elected representatives from lower-tier governments.\(^7\) Like the principles of economic and cooperative federalism, the principle of democratic federalism seeks an efficient allocation of social resources. Democratic federalism also, however, embraces the use of lower-tier governments to provide public services. Following cooperative federalism, but in contrast to economic federalism, democratic federalism does not assume the central government will automatically provide pure public goods or regulate interjurisdictional spillovers efficiently. In contrast to cooperative federalism, a majority, not unanimity, is required to make a decision. There is, however, no guarantee that a majority-rule policy will be efficient. When specifying lower-tier representation and the assignment of policy responsibilities, the

---

principle of democratic federalism requires one to balance the efficiency
gains of centralization when there are local spillovers and pure public goods
against the inefficiencies which might arise when a democratic central legisla-
ture sets policies.

Variations in non-federalist institutions of government affect how the central
legislature behaves and ultimately affect the efficiency of the federalist institu-
tions themselves. Under the principle of democratic federalism, the institutions
at issue are 1) the extent of local representation in the central legislature, and
2) the assignment of policy responsibilities to either the central or lower tiers of
government. In any central government legislature, the elected members must
overcome a fundamental structural defect of democratic choice: the propen-
sity of the majority-rule process to cycle from one policy outcome to another.
If members are to reach decisions, additional, endogenously chosen legisla-
tive institutions must be imposed to overcome this inherent instability of the
majority-rule process. Two institutional approaches are commonly used. The
first assigns agenda-setting powers to a small subset of members. Other mem-
bers in the legislature then simply vote on the items in the approved agenda.
Most likely, policies will be approved by a bare majority, a minimal winning
coalition, in this strong agenda-setter legislature. A second strategy shares
agenda-setting powers among all members, giving legislators rights to select
their most preferred policy in that policy area most germane to their con-
stituents. This approach involves each legislator deferring to the preferred
policies of all other legislators, provided the other legislators defer to the
legislator's own policy requests. The guiding norm here is one of deference,
and it can result in legislative proposals which are approved unanimously.
For this reason such legislatures are often described as "universalistic." 

A single legislator choosing between the closed rules of a minimal winning
coalition legislature or the more open rules of a universalistic legislature will
typically favor the latter. The universalistic legislature is preferred because
under universalism and its norm of deference, projects that benefit the legisla-
tor's constituents are nearly certain to be chosen. Precisely because of the ease
of passing a representative's pet project, however, universalistic legislatures
run a significant risk that their chosen policies will be economically inefficient.

The realities of political institutions clearly have strong normative implica-
tions for federalism. If, for a given legislative process and size of the legisla-
ture, the assignment of policy responsibility to the central government is less


29 For a formal presentation of the argument, see Emerson M.S. Niou & Peter C. Orde-
shook, Universalism in Congress, 29 Am. J. Pol. Sci. 246 (1985) (analyzing the decision
processes within a legislature to explain the stability of universalism); Barry R. Weingast,
A Rational Choice Perspective on Congressional Norms, 23 Am. J. Pol. Sci. 245 (1979)
discussing both minimum winning coalition legislatures and universalistic legislatures).
efficient than retaining those responsibilities at the local level, even with associated spillovers, then an ideal assignment will reallocate the activity to the lower tiers of government. The other adjustable federalism institution is the representation of lower-tiered governments in the national legislature. If the central government’s legislature operates under a norm of deference, economic inefficiencies are likely to be greater the larger the legislature and the smaller the unit of representation. For efficiency, smaller legislatures and larger units of representation may be preferred.

Under democratic federalism, assignment and representation decisions balance the efficiency gains of central government provision against potential inefficiencies. By embracing a principle of democratic federalism, however, one must assess considerations other than economic efficiency. Two other federalism objectives are potentially valuable: the encouragement of political participation and the protection of individual liberties.

Political participation ensures that representatives hear voter preferences and protects one group from the tyrannies of another. Citizen political participation may also serve an important educational function: By participating in the political process, individuals learn that their private interests are intimately linked to the interests of others. This knowledge leads to a willingness to compromise, to put private interests aside, and to call upon values of justice and common good when making public and private choices. While the evidence is sparse, what is available generally concludes that political participation, measured by voting and other forms of political action, increases as the size of government declines. Designing a federalist structure to maximize political participation therefore assigns policy responsibilities locally, and if, for reasons of efficiency or the protection of liberties, a policy is to be centralized, then participation requires extensive local representation in the central legislature.

The evidence as to which federalist structure best protects human and property rights appears mixed. Riker finds no support for the hypothesis that countries which protect small governments through decentralized federalist structures have better human rights records than centralized, unitary states. With respect to property rights, however, Weingast presents three historical case studies showing that a decentralized policy assignment for business regulation and taxation has helped to protect property rights, encourage capital formation, and stimulate economic growth. Resolving which of these competing models best protects human and property rights has direct consequences for

---

31 Riker, supra note 2, at 140.
32 Weingast, Political Institutions, supra note 3.
how we structure a federalist system. If the decentralized model is correct, then there may be no significant trade-off between rights protection and economic efficiency; indeed, protected rights promote efficiency. If, however, assignment to a broadly representative central legislature is required to protect individual liberties, then efficiency and rights protection may be in conflict.

III. CONCLUSION

Rodden/Rose-Ackerman have provided a thoughtful, constructive analysis of the Weingast model of market-preserving federalism. Their paper artfully describes some of the complexities of federalism design that may not have been given sufficient treatment by Weingast and his colleagues. It points strongly to the need for better modeling of the supply side of political institutions in a complete theory of federalism. Rodden/Rose-Ackerman do not take on that larger exercise themselves. In this Commentary I have utilized my recent experience in South Africa to suggest, consistent with Rodden/Rose-Ackerman, some of the limitations of the Weingast model. Further, I have briefly sketched out a more complete theory of federalism that I hope will respond to many of Rodden/Rose-Ackerman's concerns.