7. The Performance and Stability of Federalism: An Institutional Perspective

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1. INTRODUCTION

The literatures on the performance of federal systems divide around three central questions. The first concerns the economic performance of federalism; the second, the political performance; and the third, the sources of stability for federal arrangements.

Economists typically focus on the first question, with an emphasis on the normative aspects, such as: How ought federalism to be designed? In answering this question, the economic theory of federalism provides a theory about the optimal organization of the state, addressing issues, such as what powers should be assigned to what levels of government; why should not the central government do everything? This literature has strong positive implications, for it also explains the economic implications of alternative divisions of powers among the various levels of government.

Economists and political scientists have also focused on various political aspects of federalism, such as the degree to which the federal institutions affect the incentives of public officials. A range of results show how performance of a federation depends on these institutional arrangements underpinning the federal system. For example, a series of recent models show how different forms of tax system give subnational governments different incentives to provide public goods and foster economic growth.

Finally, the most recent questions involve how a federal system is sustained. The first two literatures take the structure of federalism as given and study its implications. This third literature treats federal structure as endogenous. To understand this question, we follow Riker (1964) and pose the twin dilemmas of federalism (de Figueiredo and Weingast 2004): Although federations differ on many dimensions, all face the two fundamental dilemmas:

Dilemma 1: What prevents the national government from destroying federalism by over-awing its constituent units?

Dilemma 2: What prevents the constituent units from undermining federalism by free-riding and other forms of failure to cooperate?

C. Ménard and M. M. Shirley (eds.), Handbook of New Institutional Economics, 149–172.

To illustrate the first dilemma, for much of the late twentieth century modern Mexico was federal in name only, as the central government centralized political authority from 1940 through the 1980s (though this trend has been modestly reversed in the last decade). To illustrate the second dilemma, consider the United States under the Articles of Confederation where the national government was too weak to provide national public goods, such as defense, policing the common market, or a stable monetary regime. In each policy area, some states had followed their common pool incentives, resulting in a series of welfare losses and disputes among states.

Although these three literatures are complementary, they remain incompletely integrated, precluding a more complete theory of the performance of federal systems. The purpose of this paper is twofold: first, to survey these three sets of works; and second, to draw on aspects of the new institutional economics and political science to suggest aspects of an integration and hence a more complete theory of federal performance.

The economics literature tells us the economic implications of alternative assignment of policies across levels of government, while the political science literature discusses the issue of what divisions are self-enforcing. As Riker (1964) demonstrates, not all types of divisions of powers within federal systems are self-enforcing. Unfortunately, the literatures on these two topics are largely separate.

The economic classics of federalism, identified with Hayek, Tiebout and Musgrave, emphasized the felicitous aspects of federalism generated through inter-jurisdictional competition and through appropriate matching of authority over public goods with different levels of government. Modern economics tends to qualify the positive conclusions of the earlier literature, analyzing incentives problems with lower governments, often emphasizing various common pool problems (race to the bottom; internal trade barriers; soft budget constraints) and intergenerational spillovers.

The underlying conceptual distinction between these two literatures is important: the classical economic works assumed benevolent governments at all levels, so certain types of incentive problems simply did not arise. The modern economics literature takes the first step in relaxing this assumption by looking at the incentive effects of lower governments, assuming that they ignore all external effects of their decisions. This reveals several types of common pool problems where decentralized decisionmaking yields problems.

Although the modern literature takes the first step, two limitations remain. First, scholars in this tradition tend to assume that local governments are benevolent governments with respect to their own citizens, ignoring how this comes about. Second, students in this tradition often retain the assumption that the federal government is benevolent and thus argue that, in the face of common pool problems, the federal government should be responsible for policymaking. Both problems limit the ability of this literature to develop a complete positive model of a federal system, treating each level of government in parallel, with its own interests and incentive problems.