

# Second Generation Fiscal Federalism: Political Aspects of Decentralization and Economic Development

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**Summary.** — This essay contributes to second generation fiscal federalism (SGFF), which traces the implications of incentives created by political and fiscal institutions. The approach explores how various forms of fiscal federalism work in the presence of political officials who, rather than being benevolent social planners, face various forms of political incentives. The paper focuses on three sets of positive models: First, it explores self-enforcing federalism; that is, how federal systems are held together given various tendencies for federal systems to become centralized or fall apart. Second, it considers how specific political institutions, such as democracy, interact with decentralization. Finally, it studies various political impediments to economic growth, again highlighting the interaction with decentralization.

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## 1. INTRODUCTION

Traditional approaches to fiscal federalism typically make a series of implicit political assumptions that limit its applicability as a positive model. For this reason, the literature distinguishes between two approaches to fiscal federalism. First generation fiscal federalism (FGFF) studies the performance of decentralized systems under the assumption of benevolent social planners. Second generation fiscal federalism (SGFF) builds on FGFF but also studies the fiscal and political incentives facing subnational officials.<sup>1</sup> The FGFF assumption of benevolent maximizers of social welfare ignores the actual goals of political officials who typically must run for election. This perspective also ignores the problem of how federal systems remain stable given the incentives of officials at the different levels to cheat on the rules; for example, by encroaching on power and prerogatives of another level. Students of SGFF study how behavior within real political institutions, such as democracy, interacts with federal institutions.

This paper adopts a SGFF perspective to address a subset of issues in the political economy of federalism, focusing on four related topics about how decentralization interacts with political institutions and incentives.<sup>2</sup> As this literature remains in the early stages, scholarship focuses on different pieces of the larger whole and does not, as yet, provide a general theory. My purpose is to pull together a few related themes in growing range of SGFF approaches to decentralization.

The first topic addresses the question, how does federalism become self-enforcing? This question explores the institutions and forces that provide incentives for political officials to honor the rules of federalism. As Riker (1964) observed, two problems pose challenges for federal stability, the centripetal forces whereby the center captures the powers of the lower jurisdictions; and fissionary forces whereby free-riding and common pool problems facing lower jurisdictions cause the federal system to fail. For example, many nominally federal countries have become highly centralized with respect to real power—including Mexico under the PRI (the Institutional Revolutionary Party that dominated Mexico from roughly 1930 through the mid-1990s; see Diaz-Cayeros, 2006) and India under the

Congress party (1950 through the late 1980s; see Roa & Singh, 2005). To remain stable, federal systems with significant policy decentralization must counteract both these forces.

Second, a related issue concerns the assignment problem. How are various policies in a federal system assigned to different levels of government in practice? FGFF has a well-developed normative theory of assignment. What explains why different federal systems assign policies in different ways? Models in the literature tend to reveal various political impediments to the efficient assignment and production of public goods. Unfortunately, students of fiscal federalism have only begun to point toward answers to these important questions.

Third, I discuss several problems involving how democracy interacts with decentralization. After observing that elections and democracy do not provide magic solutions to problems of development, I raise the issue of sequential decentralization rather than decentralization through one great leap. I next raise the problem of “tragic brilliance,” a pernicious use of decentralization by which political officials use elections in the context of decentralization to manipulate citizen behavior rather than the other way around. In many developing countries, local public goods are not administered to all citizens who can pay their bills or taxes, but instead are discretionary on the part of a highly centralized regime (Diaz-Cayeros, Magaloni, & Weingast, 2006). Specifically, the regime uses this discretion to convert democratic elections from a system of citizen choice to one controlling citizen electoral behavior. The regime does so by rewarding those districts that support it (with financing for local public goods) while punishing those which fail to support it (substantially less financing for local public goods). Because local public goods are highly valued, the threat of withdrawal if they vote for the opposition forces many citizens to support the regime.

Fourth, I raise political impediments to development and how decentralization can mitigate them. An important

\* This paper draws on the author’s larger project on second generation fiscal federalism, especially (Weingast, 2009). The author thanks Jean-Paul Faguet for helpful conversations.

problem in development involves creating perpetuity, the idea that organizations and institutions are stable beyond the lives of those who create them. For example, business partnerships are finite lived (they must be dissolved or reconstituted when a partner dies); while corporations are perpetual (shares are typically inherited or sold when a shareholder dies). Most developing countries have limited or no perpetual institutions, so new leaders often alter institutions and policies to suit their purposes. An extreme version of this problem involves the predatory state, one whose leaders opportunistically change policies and institutions to extract rents from citizens. I suggest how decentralization can mitigate these problems under some circumstances. This discussion considers some normative aspects of the positive, SGFF ideas, drawing several implications for the design of decentralization. This discussion includes the idea of initiating federalism “one step ahead”—decentralization which first allows one region (such as that most likely to succeed in decentralization) to experiment with decentralization.

This paper reveals two general themes that arise from the various topics. One theme is that a wide range of incentives favor inefficient policy choice, especially the inefficient assignment and production of public goods. The other theme is centralization. The paper reveals several independent motives for political officials in the central government to centralize power, authority, and fiscal resources.

This paper proceeds as follows. Section 2 raises the issue of self-enforcing federalism. Section 3 discusses SGFF approaches to the assignment problem. Section 4 turns to problems of democracy, while Section 5 discusses how decentralization can mitigate the impediments to democracy posed by a predatory state and by the lack of perpetuity. My conclusions follow, including the theme of centralization.

## 2. SELF-ENFORCING FEDERALISM

How do federal states hold together? Riker (1964) and, more recently, Rodden (2006) and Stepan (2004), emphasize the *two problems of federal stability*. In some federal systems, the national government overwhelms the subnational governments, producing a centralized state. Others face intractable problems of free-riding by the subnational governments and dissolve into separate states. A federal system is *self-enforcing* when political officials at all levels of the hierarchy have incentives to honor the rules, including one another’s powers and authority. Self-enforcing federalism, therefore, requires incentives and mechanisms that mitigate or solve the two problems of federal stability.

No widely accepted theory of self-enforcing federalism exists. A large literature suggests that certain institutional features of democracy are more likely to preserve decentralization.<sup>3</sup> The literature associates a range of institutions with stable decentralization; for example, when subnational officials are elected, in contrast to serving at the pleasure of the national government; or when the constitution designates that the subnational units have direct representation in the government (e.g., in a “senate”).

In this section, I summarize four theoretical ideas that contribute to self-enforcing federalism. The first considers the role of political parties in maintaining the federation. A host of writers follow Riker (1964) and argue that the form of the party system is essential to maintaining federalism.<sup>4</sup> Some party systems allow national elites to dominate the parties; others allow local elites to dominate; and still others afford a balance of power among national and local elites. When na-

tional elites dominate parties, they are likely to force local leaders to accept (or acquiesce to) institutional changes that compromise local government powers (as in Mexico under the PRI, India under the Congress Party, or Russia under Putin). In contrast, a party system dominated by local elites is more likely to force national elites to accept subnational government common pool abuses, such as bailing out subnational deficits (as in Brazil in the late 1990s). Finally, a party system balanced between national and local elites is more likely to support decentralization, as both local and national elites guard their own prerogatives (as in the US). This perspective begs the issue of what creates different types of party systems (though see Filippov *et al.*, 2003, who argue that the electoral system generates the party system; see also Cox, 1997).<sup>5</sup>

No satisfying statement of the role of parties in preserving federalism exists. But the essence of the argument, I believe, can be summarized as follows. To succeed, federalism must have an integrated party system, which requires two conditions. First, politicians must have incentives to cooperate across political levels and jurisdictions in order to win elections; and second, once in office, political officials must have incentives to abide by restrictions on their power and refrain from encroaching on the powers and prerogatives of the other level. Such a system, for example, may have local politicians who rely on national brand name or reputation of their party; and national politicians, unable to create their own independent national organization to mobilize sufficient votes to capture power, who must cooperate and mobilize local political organizations in order to win national elections. In this setting, political officials across levels must cooperate with rather than attempt to take advantage of one another. This creates a vertically integrated political system.<sup>6</sup>

Incentives hold the federal system together. Politicians from the same party at both levels of the federation need one another to win national and local offices. Once in office, officials at each level are tempted to encroach on the powers and authority of the other. But each has countervailing incentives to resist such encroachment. The reason is that major encroachments usually create discord between levels; as the target of encroachment resists, cooperation fails. Discord and lack of cooperation between levels, in turn, gives the *opposite* party a competitive advantage in the next election. Because this outcome makes both national and local officials in the party worse off, they have incentives to forgo encroaching on the powers and prerogatives of the other level. In short, these scholars argue, federal parties are essential to the maintenance of a federal system.

This argument has some obvious missing links. For one, we know too little about how to assemble the institutions of federalism to balance these incentives in a way that holds the federation together.<sup>7</sup> For another, this argument ignores the complication that politicians from the same party may be in and out of office. Thus, if party A holds power at the national level while party B holds power in most units at the lower level, might A be tempted to encroach on decentralization as a means of weakening the ability of party B to succeed in their policy goals?

In a second approach, de Figueiredo and Weingast (2005) model federalism as a repeated game with an initial constitutional period followed thereafter by the following repeated game (see also Bednar, 2009). In each stage, the federal units have opportunities to free ride; the center has the authority to police free-riding, but it may also abuse that authority by encroaching on the authority of lower governments. In the constitutional period, the federal states decide whether to create a federal unit, and if so, to create set limits on the

center's behavior on which they will coordinate against the center if ever the center violates these limits. These limits are not binding; they are instead constructed focal solutions to the coordination problem whereby the states can police the center if they react together in the repeated game to police the center's abuse of power. The model shows that, as long as the federation is sufficiently value-enhancing, an equilibrium exists in which all parties can police the federal bargain. Coordination is critical to this result, and hence the need for a constitutional moment whereby the federal units agree on how to coordinate.

Bednar, Eskridge, and Ferejohn (2001) provide an approach that complements the repeat play incentives highlighted by de Figueiredo and Weingast (2005) and Bednar (2009). The latter models involve a stable setting repeated over many periods. Bednar, Eskridge, and Ferejohn discuss the problem of adaptive efficiency (Hayek, 1960; Mittal, 2010; North, 2005); namely, adapting the Constitution to changing circumstances as ambiguities and unforeseen circumstances arise, potentially leading to disputes.

Bednar, Eskridge, and Ferejohn's approach to self-enforcing federalism centers on the role of the Supreme Court in interpreting the US Constitution; in particular, on the Court's role in policing the rules of federalism from encroachment by either the national or state governments. The Supreme Court, they argue, seeks to maintain its role as arbiter of the Constitution. It therefore has an institutional incentive to police federalism as part of its larger goal as arbiter. To succeed, the Supreme Court must provide significant value to citizens, and the Court adjusts federalism in parallel with the changing circumstances. To the extent that focal points help citizens coordinate, as in Bednar (2009) and de Figueiredo and Weingast (2005), then the Supreme Court provides value to citizens by facilitating coordination through the construction of new focal points and adapting existing ones to changing circumstances.

Inman and Rubinfeld (2011) study the important transition in South Africa from the minority white-dominated apartheid system to a democratic and federal government with a large black majority. A major problem arises in the new country because the median black voter is tempted to expropriate the whites, leading to many economic problems, such as decapitalization and the flight of highly skilled labor.

Inman and Rubinfeld argue that mixing blacks with whites in a white dominated jurisdiction limits the central government's incentives to expropriate the whites. First, whites have high human capital and are therefore low cost providers of redistributive public goods and services, such as education and health care. Second, if the center expropriates the whites, the whites will exit the public service economy (either to enter the private economy or to leave the country). Inman and Rubinfeld show under a range of plausible parameters that, if the center wants to maximize the welfare of the average black, it will want to take advantage of the white's ability to provide public services at low cost. Under these circumstances, democratic federalism is stable.

The models discussed in this section study different aspects of an important SGFF question, how is a federal system sustained given incentives by officials in different levels of government to encroach on one another's prerogatives. We know too little about this problem, and the models so far do not add up to a general theory.

### 3. POSITIVE MODELS OF THE ASSIGNMENT OF PUBLIC GOODS

Positive models of the assignment problem should represent a central topic in SGFF. These models attempt to parallel the

extensive normative literature on the assignment problem indicating which goods should be assigned to the different levels of government in a federal state (standard FGFF on this topic include Musgrave, 1959; Oates, 1972, 1999). Oates's (1972) famous "decentralization theorem" remains central to the FGFF approach; it holds that when differences in preferences across regions are large and spillovers are small decentralized authority over public goods is preferred. Unfortunately, the approach remains in its infancy. All of the models in the literature study special cases, and they do not add up to a general approach.

In recent years, a positive literature has begun to emerge that asks under what conditions, if any, does the decentralization theorem hold in practice (Besley & Coate, 2003; Cremer & Palfrey, 1996; Lockwood, 2002, 2008). The goal of these models is twofold: first, to explain the how assignment works in practice; and second, to evaluate whether public goods are provided efficiently. A central lesson of this literature is that introducing political mechanisms to decide on the assignment of policies leads to political biases and inefficiency.

For example, several scholars study the relationship between the distribution of preferences and the provision of public goods. Suppose there exists a significant skew in the distribution of voter preferences for public goods so that the median voter's preference lies above the mean preference. Then the median-driven majority over-provides public goods (Besley & Coate, 2003; Lockwood, 2002, 2008). In other words, majority rule fails to allocate public goods assignments in accordance with the decentralization theorem; SGFF results do not mimic those of FGFF.

In an important paper that investigates a model of political choice in a federal setting, Cremer and Palfrey (1996) provide a positive model of the assignment of public goods to different levels of government based on citizen preferences. The model abstracts from all considerations of efficiency, including differential costs of production based on local conditions or economies of scale. Citizens have the choice of voting between local production of the public good and national production. Voters vote for the level that provides them with the highest benefits, assuming that centralized provision involves uniform provision across all lower units. When lower units are homogeneous but differ markedly from one another, voters generally vote for decentralized production. Cremer and Palfrey also show that there exist cases where the lower units are heterogeneous so that most units choosing by majority choose decentralization, but a majority across all the units prefers centralization. In this case, voters choose to centralize. Their model is specialized, but provides the basis for more general positive models of the political choice of assignment.

Volden (2005) studies intergovernmental political competition in American federalism. His model suggests that competition between officials at different levels can lead to the over-production of public goods. The reason is that political officials from both levels of government, in their separate efforts to claim credit with voters, provide elements of the same public good. Efficiency in production matters as well. If one level can produce the good much more cheaply, then it dominates production and provides the efficient level of the public good. But when one level can produce the good somewhat more cheaply, both levels participate in production, leading to over-production.

Hatfield and Padro i Miquel (2012) study the relationship among the distribution of income, capital taxation, public goods provision, and investment.<sup>8</sup> From the median voter's perspective, higher taxes have the prospect of more redistribution, but they also cause less investment. In other words, a

tradeoff exists between the size of the economy and the tax rate. Hatfield and Padro i Miquel (2012) then back up a stage to the const to infer the optimal degree of decentralization, which places limits on taxation and redistribution, allowing the median voter to commit to lower taxes and less redistribution.

As a final illustration, Wallis and Weingast (2012) examine the provision of infrastructure in the early 19th century US. The puzzle is that, despite the presence of large spillovers, the states provided the largest and most valuable projects. Using models of legislative choice, Wallis and Weingast show that Congress could not finance projects that provided benefits to a minority of districts while spreading the taxes over all. Although states faced the same political problems, they could use benefit taxation schemes that coordinated taxation and benefits—for example, by assessing property taxes on the basis of the increase in value due to an infrastructure investment. The US Constitution required that the federal government to allocate direct taxes on the basis of population, effectively prohibiting benefit taxation. Here, too, the SGFF results diverge from those of FGFF.

No general theory emerges from these separate models. Nonetheless, they all point in the same direction, emphasizing various political impediments to the efficient assignment and provision of public goods.

#### 4. DEMOCRACY AND DECENTRALIZED GOVERNANCE

Democracy is perhaps the most celebrated form of governance and political accountability. Elections potentially allow citizens to influence their own destiny by choosing one set of officials instead of another. Citizens also use voting to help police their rights. As James Madison emphasized in the *Federalist Papers*, the threat of being thrown out of office provides political officials with incentives to make decisions that reflect their constituents’ interests, including honoring citizen rights (see Riker, 1982).<sup>9</sup>

Nonetheless, elections are not a cure-all; they do not automatically police elected officials, preserve citizen rights, and promote economic growth (Besley, 2006; Persson & Tabellini, 2000). This section discusses the interaction of decentralization and democratic governance. It suggests ways in which decentralization can strengthen democracy and ways in which centralization can weaken democracy. Before we turn to this interaction, however, we must understand some of the limits of democracy, elections in particular.

##### (a) Democracy’s limits

Small “d” democrats consider democracy such an attractive value that they too often fail to worry about the conditions under which it is more likely to succeed. Three aspects of democracy are critical for our analysis of democracy, one empirical and two theoretical.

Consider the empirical aspect first: Most new democracies fail, either due to coups or to “democratic set-asides” (incumbents cancel elections or refuse to step down after losing an election), especially in poor countries. Elkins, Ginsburg, and Melton (2009, p. 135) show that most new democracies fail. The average democratic constitution lasts but 16 years.

Moreover, the evidence is striking that democracy is far more likely to succeed in richer countries. Przeworski (2006) estimates that the frequency of a democracy failing each year in a country with a per capita income of less than \$1,000 per

Table 1. Estimated probability of democratic survival by income level  
Source: Przeworski (2006, p. 314)

Income level	Estimated probability of failure per year	estimated probability of surviving 10 years
<\$1,000	.085	.41
1,000–3,000	.036	.69
3,001–6,055	.016	.85
>6,055	.00	1.00

Przeworski’s income figures are in 1985 purchasing parity dollars.

year is .085 or one in twelve (see Table 1); with a per capita income of \$3,001–6,055, it is .016 or one in sixty-one; while no democracy with a per capita income of greater than \$6,055 has failed.<sup>10</sup> Put another way, the table also shows that a democracy in the poorest category has only a .41 chance of remaining a democracy one decade later; in the \$1,000–3,000 category, the probability is .70; in \$3,001–6,055, .86, and 1.00 for the highest income category.

The first theoretical aspect of democracy reflects the costs of democracy. This idea sometimes comes as a surprise, in part because scholars and policymakers focus on the benefits of democracy. Indeed, democracy has costs and can pose dangers to citizens. Elections empower governments to tax, regulate business, define property rights, and jail people. All these powers can be abused, as tyranny of the majority suggests. And even if not abused, these powers may impose sufficiently large costs that some citizens support extra-constitutional action and violence as a means of defending themselves.

The dangers of democracy are difficult for people in the developed west to understand because democracy in these countries allows citizens to determine their own destiny. But democracy in developed countries is embedded in a series of institutions and norms that complement elections by placing striking limits on government policymaking and therefore protecting citizens from many potential abuses. Courts and other institutions, for example, enforce a wide range of citizen rights; and elaborate procedures constrain the range of feasible policies. Indeed, the importance of legal systems in the developed west capable of upholding citizen rights against the government demonstrates that elections alone cannot sustain citizen rights. Yet democracy in the developing context typically lacks these complementary institutions that help sustain it.

The second theoretical aspect of democracy also concerns the costs of democracy. Specifically, all successful democracies satisfy the *limit condition*, namely, that various institutions and incentives limit the stakes of power by restricting the scope of policy authority of elected representatives (Mittal & Weingast, 2013). Successful democracies limit the stakes of power through the constitution and other institutions that protect a range of citizen rights and other aspects of the status quo. Events in Chile reveal the centrality of the limit condition, where in 1973 the legitimately elected government threatened landowners and others on the political right, leading them to support a bloody coup. When citizens believe they are protected under the system, they are far less likely to support extra-constitutional action, such as coups. Democracies that satisfy the limit condition are therefore more stable.

The absence of the limit condition in the developing context reveals a critical difficulty with sustaining democracy in the poorest and under-institutionalized countries—these states face grave difficulties maintaining institutions that satisfy the limit condition.

(b) *Limited vs. open access orders*

The single biggest element missing from the economic approaches to development is the problem of violence (Cox, North, & Weingast, 2011).<sup>11</sup> Such theories fail to take into account the systematic threat of violence. Violence is common, if episodic, in virtually all developing countries. To the extent that developing countries maintain peace for extended periods, they do so by taking great pains to limit violence.

Before we turn to how developing countries limit violence, we need a distinction between limited and open access. In *limited access*, only some individuals and groups can form organizations. These societies therefore limit the size and scope of their civil society. In *open access*, a society allows all individuals and groups to form organizations that can access support for organizations (such as contract law, corporate form, etc.). As North *et al.* (2009) show, almost all developing countries are limited access societies whereas the developed ones are open access.

Unfortunately, the means by which developing countries limit violence typically hinder development. In most developing countries, access to violence is distributed. The state rarely has a monopoly on violence. In this circumstance, creating peace and order requires that those with access to violence believe themselves better off cooperating than fighting. To create these conditions, these countries grant various forms of privileges to the powerful so that they value peace over attempting to use force to capture benefits. But granting privileges to factions with access to violence necessarily limits access. Moreover, attempts to create open access in such societies lead to many problems. First, open access conflicts with granting privileges to powerful groups—new organizations can compete with those supporting privileges to the powerful. Second, open access allows an opposition to organize and contest power, again threatening the privileges of those with access to violence.

A further aspect of using privileges to prevent violence is that agreements to create privileges and peace break down with some frequency. The reason follows North's (1981) emphasis on changing "relative prices," the omnipresent changes in various parameters underlying a society's equilibrium, including large swings in prices (e.g., for a country's primary products or inputs), weather disasters, demographic events, technological change, and so on. Each of these changes affects the relative power of various groups, often in asymmetric ways. When groups gain sufficient power, they are likely to demand greater benefits. Asymmetric information in this setting—for example, about the relative changes in power—plagues the peaceful renegotiation of agreements, potentially resulting in violence.

This perspective has an important implication for decentralization. To the extent that the national government in developing countries allocates resources and creates privileges in proportion to violence potential, then centralization of policy authority has significant political advantages. In this context, decentralization had disadvantages because it lowers the discretion of officials at the national level to manipulate policies so as to prevent violence.

Developing countries have two additional problems not widely recognized but which dramatically affect their performance. Both problems involve the relative inability of developing countries to make credible commitments, whether to institutions or to policies. The first aspect of credible commitments involves perpetuity. An organization or institution is *perpetual* if its existence does not depend on the individuals who created it. A business partnership is not perpetual because it must be dissolved or reorganized on the death of any partner. A corporation, in contrast, is perpetual; its shares may be

sold and inherited, so its existence has the potential to live beyond the lives of the individuals who create it.

The same concept applies to political institutions, including the constitution. A society that can create credible commitments to its constitution creates perpetual institutions that live beyond those who create them. Not only do today's political officials have incentives to honor them, but so too do tomorrow's. Similarly, a society without perpetual institutions means that tomorrow's leaders can alter the institutions to suit their purposes. In particular, institutions to control moral hazard by the executive are weaker or absent in countries lacking perpetuity.<sup>12</sup>

Most developing countries lack the ability to create credible commitments that endow their institutions with perpetuity (North *et al.*, 2009, chap. 2). The personal basis of limited access orders means that benefits flow to those who can disrupt the regime, for example labor unions through debilitating strikes or the military through coups. If such benefit-flows fail to occur, these groups use their ability to disrupt to gain more benefits.<sup>13</sup> The threat of powerful groups in developing countries to create various forms of disorder and violence makes credible commitments difficult. The reason is that, as the identity of those with power to disrupt changes over time, so too must benefit-flows.

The lack of perpetuity means that new leaders can engineer major changes in political institutions almost at will. Needless to say, institutions are far less constraining in such regimes, including the ability to respect rights. Executive re-engineering of political institutions to suit their interests and remove constraints is relatively common in the developing world. Consider President Vladimir Putin's re-engineering of Russian institutions after his takeover from President Boris Yeltsin; President Hugo Chavez's institutional changes in Venezuela; Pinochet's in Chile following his coup in 1973; or, to mention a far more notorious one, Adolph Hitler's transformation of Weimar into Nazi Germany.

The main implication of the absence of perpetual institutions is that today's policies are highly vulnerable, especially to changes in leadership. The lack of credible commitments means an absence of rights that economic agents can count on. Threats of the outbreak of violence means some contracts creating value will not be written because they make one or both parties vulnerable in the event of violence.

(c) *Democracy and decentralization*

Democracy interacts with decentralization in a wide variety of ways. First, an odd feature of the promotion of democracy around the world is that these efforts nearly always focus on the national government. The absence of the limit condition and of a wide range of perpetual institutions to protect citizen rights implies that national elections create great risks and potential instability for citizens. Legitimately elected officials, acting within the political rules (given the relative absence of institutional constraints) can threaten various groups with legal confiscation of property and sources of income. In the presence of such threats, those threatened will support extra-constitutional action, such as coups and democratic set-asides. National democracy without the limit condition is likely to be unstable.

Second, democracy without the limit condition often conflicts with the need for most developing countries to sustain peace by distributing privileges to the powerful. As the median voter typically loses from these privileges, the logic of median-driven democracy directly conflicts with these privileges. Put another way, privileges often conflict with the goals of democracy—letting the people decide their fate. For this reason, creating stable

democracies in developing countries is more problematic than democrats acknowledge.

A special case of this problem arises in developing countries that need to use privileges to give those with access to violence the incentive to cooperate and maintain peace. Peace and order in these settings require that elected officials must have incentives to preserve the bargains that grant privileges to those with access to violence. Democracy that fails to impose various substantive and procedural limits to protect privileges is more likely to fail. Post-Mubarak Egypt has just this problem. The military has power and says it will help initiate democracy. But the military under President Mubarak was highly privileged, involved by some accounts in a third of the economy. Democracy that threatens such privileges (or that fails to compensate the military in some way), is therefore problematic. Indeed, because of the threat to the military's privileges, it is not clear at all that the military will make good on its promise to initiate democracy.

A final problem concerning democratization that focuses on the national level involves an issue discussed in the section, namely the role of parties in sustaining federalism. To the extent that the cooperation of political parties at the national and local levels helps sustain decentralization, democratization that focuses on the national level is likely to lead to greater centralization than democratization that emphasizes both national and local elections in the context of decentralized power over policymaking.

What is to be done? An alternative strategy is to initiate democracy at the local rather than the national level. Building democracy from the bottom up greatly reduces the risk, in part because subnational governments have less policy authority.<sup>14</sup>

Building democracy through decentralization has several advantages. First, a sequential program for democratization that begins at the local level is therefore an alternative to initiating unstable democracy at the national level. Once successful political competition emerges at this level, steps can be taken to open national politics to the democratic competition. Moreover, whereas most authoritarian regimes are unwilling to initiate full national democracy, these regimes may find a strategy of sequential democratization more attractive since initiating local democracy is less threatening.

Importantly, one of the most stable new democracies, Taiwan, made the transition to democracy through a series of steps that began at the local level and slowly built up to democracy at the national level (Diamond & Myers, 2001). Taiwan's sequential strategy has created a stable, modern democracy.

Hiskey (2006) and Thomson (n.d.) provide a variant on the theme of sequential democratization by suggesting that special districts provide an important way to initiate democracy in authoritarian regimes without a wholesale devolution of power or local democratization: "the creation of special districts that encompass multiple localities can provide a much needed 'training grounds for self-governance short of wholesale devolution of power and authority to all general purpose [Local Government Units] in a given country, the scale of the change is usually less extensive and more focused as regards special districts'" (Hiskey, 2006, p. 22, quoting Thomson *et al.*, 2004, p. ix).

Second, decentralization contributes to the limit condition in another way that involves party politics. In a centralized country, losing a national election is very costly to the incumbent and its supporters. Incumbents therefore have incentives to hold onto power despite losing. In the absence of the limit condition, it may simply be too costly to give up power.

In a decentralized state, however, losers can typically maintain a local power base from which to remain politically visible and to provide some benefits to their constituents. Local political strongholds also provide a base from which this party can

launch a future attempt to recapture national power. By lowering the stakes of power, decentralization makes it more likely that losers of national elections will give up power. Lower stakes also reduces the probability that challengers who lose elections will fight rather than accept their loss.

Third, a growing literature studies the relationship between decentralization and conflict in divided societies; that is, states with ethnic, cultural, or linguistic differences.<sup>15</sup> In some cases, decentralizing authority to regions with more homogeneous populations allows these groups to live in harmony within a larger state, which seems to play a role in "holding together" Belgium, India, Spain, and the Netherlands (Lijphart, 1975; Stepan, 2004). The same held for the early US, where decentralization of some of the most divisive issues—such as slavery—allowed Americans to maintain their country united for three generations prior to the Civil War. Decentralization has also seemed to mitigate conflict in Indonesia and the Philippines. Inman and Rubinfeld (2011) argue that decentralization was essential to the democratic transition in South Africa. Whites were willing to promote the transition because decentralization provided sufficient security to them.

In contrast, decentralization sometimes exacerbates conflict in divided societies (Snyder, 2000; Treisman, 2007, chap. 10). Eaton (2006), for example, argues that decentralization in Colombia exacerbated its conflict because the control of local governments provided the different groups with resources and authority useful for fighting. The bottom line is that we know too little about whether decentralization—or under what circumstances in combination with which specific forms of decentralization—helps mitigate conflict.

Finally, Myerson (2006) argues that decentralization adds to the success of democracy in another way; namely, to help incubate candidates for national office. Subnational office allows officials to gain experience and reputation. Decentralization therefore provides national voters with more information about the candidates, and they can pick for national leaders those who have been especially successful at the subnational level.

(d) *Tragic brilliance: How insecure governments use centralized fiscal control to undermine elections*

Democracy has other potential liabilities that arise from decentralization in the developing context. In what follows, I summarize the "tragic brilliance" mechanism used by an authoritarian or weak democratic regime that allows the government to pervert elections so they serve as a mechanism of social control rather than citizen choice (Diaz-Cayeros, Magaloni, & Weingast, 2005).

As noted, democracy in the developed west satisfies the limit condition—these countries impose credible limits on what democratically elected representatives may do (Mittal & Weingast, 2013). Citizens enjoy a wide range of rights and public goods and services by virtue of citizenship, not based on a political relationship with those in power. In particular, standard local public services—such as water, electricity, education, sewage, garbage, and road maintenance—do not depend on whom an individual or a locality votes for.

Elections in many authoritarian and weak democratic regimes often differ dramatically from this ideal. In Mexico under the PRI—the Institutional Revolutionary Party that virtually monopolized power from 1930 through the early 1990s—elections served a very different purpose than citizen choice. Although Mexico has long been a federal system, the PRI engineered a very centralized one (Diaz-Cayeros, 2006), where the central government raises most of the revenue and finances most state and local expenditures through transfers.

In the 1980s, the average local government received over 80% of its revenue from higher governments.<sup>16</sup>

Although this pattern of revenue generation and spending conforms to that recommended by FGFF, its purpose was not to further citizen welfare. Instead, the PRI used its discretion over revenue to threaten localities who supported the opposition by withdrawing funds to finance local governments. Most local services require substantial revenue. The threat to withdraw revenue forced opposition-favoring citizens to face a dilemma: voting for the opposition meant a far smaller level of public services. This credible threat causes most moderate opposition-leaning voters to support the PRI. Revenue centralization thus afforded the PRI the discretion to force most voters to support it at the polls, even voters who preferred the opposition.

As evidence, the case study literature shows that when the first two cities, Ciudad Juarez and Chihuahua, voted in the opposition in 1983, the cities lost on the order of half their budgets (Rodriguez, 1995; Rodriguez & Ward, 1995). Similarly, in a study of approximately 1,800 of 2,400 Mexican municipalities from a more recent period, Diaz-Cayeros *et al.* (2005) provide econometric evidence showing that municipalities that supported the opposition received on average one-quarter less revenue.

Land reform in Mexico reveals another aspect of the tragic brilliance mechanism: reform policies often fail by design. Economists demonstrate that significant increases in the equity of land distribution improve both economic growth and income equality (Alesina & Rodrik, 1994), but this has not been the case in Mexico. Diaz-Cayeros *et al.* (2006) show that the central government designed land reform in Mexico to create political dependence. Peasants receiving land did so as communities rather than as individuals. Until recently, peasants could not sell, lease, or use the land as collateral. These policies created agricultural collectivities that were closer in spirit to the soviet collective farms than to the types of land reform that increased economic growth in Japan, Korea, and Taiwan (Alesina & Rodrik, 1994), where private property right systems created far more efficient land use.

Mexican land reform produced marginal farms, and a great many of the collectivities required subsidies in the form of water, seeds, and fertilizer to provide a living. The subsidies, in turn, created political dependence: as long as the farms remained marginal, the farmers had to support the PRI to maintain their subsidies.

The tragic brilliant mechanism represents the pathology of both democracy and decentralization. It is tragic because it forces opposition-leaning citizens to play an active role in maintaining a regime that they would rather replace; but also brilliant in that authoritarians use their policy discretion to create political dependence and subservience while providing the outward veneer of elections, choice, and democracy.

The tragic brilliance mechanism reveals a political motivation for why regimes in developing countries centralize policy and taxation authority in comparison with developed ones.<sup>17</sup> Wholly apart from administrative efficiencies and fiscal equity, centralization affords insecure political regimes with political leverage over lower governments and citizens. By making the delivery of basic local public goods and services depend on whom citizens vote for, the incumbent regime at once restricts citizens ability to throw the rascals out, to exercise fiscal autonomy, and to influence public policies.<sup>18</sup>

The main lesson is that, for democracy to serve as a mechanism of freedom and choice, it must be embedded in institutions that constrain the government's use of discretionary fiscal authority to threaten voters who vote for the opposition. Preventing the operation of the tragic brilliance mechanism

therefore presents another SGFF rationale for decentralizing fiscal authority. Independent taxation authority allows local governments not only a fiscal interest in fostering local economic prosperity, but also a much greater degree of independence from a controlling (and potentially predatory) center.

## 5. IMPLICATIONS FOR DESIGN OF DECENTRALIZATION

Thus far, this paper has concentrated largely on positive issues associated with SGFF. It now turns to normative ones raised by the various discussions of potential problems associated with implementing or sustaining federalism. In this section, I consider several strategies for implementing decentralization, especially in the presence of predatory governments.

### (a) *Political impediments to successful decentralization*

Predatory central governments are a problem throughout the developing world, and these governments hinder the operation of an otherwise well-designed federal system (see, e.g., Dixit, 2004; Shleifer & Vishny, 1998). A predatory central government that faces relatively few constraints on its behavior can reverse or compromise any and all of the benefits of decentralization. No magic cures exist for this problem. Further, even a developing country government that is not predatory is likely to lack perpetuity and other forms of credible commitments.

A common and yet insidious form of predation perverts the logic of innovation and competition in a local government exhibiting policy independence. Suppose a particular subnational government creates a thriving local economy that stands out in comparison with other regions. A predatory central government may well expropriate the value of successful firms. Moreover, this economic success potentially provides local political officials with a resource and political base with which to challenge national leaders, either to extract greater concessions or freedoms; or to challenge their leadership. Predatory or insecure central governments therefore have incentives to prevent local governments from succeeding. National leaders of predatory states may therefore use their powers to reduce or remove the authority of the local government; they can expropriate control of all successful enterprises; or they can take over the local government and reverse its policies. Crook and Manor (1998) provide an instructive example of how the dominant Congress party in India dismantled the successful opposition Janata Party's ruling of the state of Karnataka in the 1980s. But it is easy to see that local jurisdictional independence is highly unlikely in a great many developing countries. Mubarak's Egypt, Castro's Cuba, Qaddafi's Libya, Saddam Hussein's Iraq, present-day Iran, the PRI-dominated Mexico, and many others show that many rulers throughout the developing world countenance little local political and fiscal independence.

The economic side of this problem is even worse. Predatory governments often expropriate the value of new enterprises, especially ones not politically connected to the dominant coalition in power. The risk of a predatory reaction by the central government feeds back into the local economy, making it less likely that economic agents will make investments that can be expropriated even if these would be profitable under the local government's policies. It may well be that truly predatory governments have little hope of reform.

Furthermore, underlying the predatory government problem is a commitment issue. Reform-minded governments may create a new policy allowing entrepreneurs to make profitable investments, but they cannot commit to honoring that

policy. Economic agents are therefore reluctant to make investments even if they are profitable under the new law, fearing that the government will not honor the law or will revise it ex post in a manner unfavorable to them.

As noted at the outset, similar problems arise in non-predatory governments that lack perpetuity. The inability to bind today's rulers and their successors to institutions and policies means that even reform-minded governments cannot guarantee that their policies and institutions will survive their tenure in power. This source of political risk lowers the expected returns from investment.

(b) *Decentralization as a means to overcome predation*

China's successful creation of market-preserving federalism in the 1980s suggests one way around the commitment problems involving a predatory and hence non-perpetual government. SGFF logic emphasizes that, to be sustained, FGFF's normatively attractive form of federalism requires institutional limits that provide some form of credible commitment by the central government to honor the rules of the federal system. Whether by design of happenstance, China's reform-minded leaders accomplished this condition in two ways. The first and perhaps more important was fiscal; the second was unintended.

Communist China had a long history of anti-market policies, mass murder, and other forms of predation. This predatory behavior strongly impeded market reform, investment, and economic growth. Economic agents had no reason to believe that such a government would honor economic reform policies rather than, at some point down the road, reverse itself and punish those successful under reform. Communist China under Mao exhibited several massive policy reversals with exactly that type of punishment; notably, in the Great Leap Forward and in the Cultural Revolution.

This form of political risk meant that economic reform in the post-Mao era had, somehow, to limit the arbitrary authority of the central government.<sup>19</sup> China's strategy in promoting economic reform was decentralization consistent with fiscal federalism; the central government devolved economic policy-making (policy authority condition) and fiscal authority (including the hard budget constraint) to the provinces (Montinola, Qian, & Weingast, 1995; Oi, 1992; Shirk, 1993). This new policy authority allowed the reform-oriented provinces to switch from socialist policies to pro-market ones. Provinces also faced strong fiscal incentives to promote reform under what the Chinese called the "fiscal contracting system," 1981–92 (see Oksenberg & Tong, 1991). Under this system, most provinces raised their own tax revenue under a fiscal contract with the central government. Many contracts took the following form: the province shared 50% of all revenue raised up to a specified revenue level with the central government and then the province to retain 100% of all revenue beyond that level. The average province faced a marginal tax retention rate of 89%; and 68% of all provinces faced a marginal retention rate of 100% (Jin, Qian, & Weingast, 2005). Reflecting strong fiscal incentives to promote reform, many provinces quickly grew rich as their economies mushroomed.<sup>20</sup>

Per SGFF logic, as the reforms succeeded, fiscal authority granted the provinces both the incentive and political power to act independently of the central government. The fiscal incentives also had strong political effects on constraining the central government. Because most provinces benefitted from, had significant investment in, and grew rich from the fiscal system, they had the political power to counterbalance the central government. For example, a conservative reaction against reform followed the suppression of the protests in Tiananmen Square in

1989. Provincial leaders—in particular, the governor of the most successful reform province, Guangdong—used this power to prevent the proposed anti-reform reaction (Shirk, 1993, pp. 194–95; see also Montinola *et al.*, 1995).

A second mechanism arose to raise the costs to the central government of an anti-reform, anti-market reaction, although this one was not by design. An important aspect of Chinese economic reform is the floating labor population, workers from the interior who come to the coastal reform provinces to work. These laborers could not become local citizens but instead worked under a system of limited rights—effectively an intra-China guest worker system (Solinger, 1999). Host provinces retain the right to send these laborers back to their home provinces. This labor population is now huge—well over 100 million workers.

The existence of a huge floating labor system has a striking political implication: the most likely response to an anti-reform reaction by the central government is for the reform provinces to kick out many or most of the floating laborers. This means that 10s of millions of people—perhaps approaching 100 million—would instantly become a problem for the central government: how would they be fed, clothed, and housed? Because hungry people can topple governments, this potential reaction represents a significant hurdle before political leaders who might be tempted to impose an anti-market reaction to economic reform.

The main implications are twofold. First, although China's devolution of power to the provinces at the inception of economic reform was discretionary, the reform's success created strong power centers in the provinces that counterbalanced the center's discretion.

Second, the Chinese case has important lessons for the design of decentralization in poor countries traditionally plagued by predatory or under-institutionalized governments. One circumstance is a fiscal or other crisis. A crisis often means that the current government coalition cannot be sustained. As donor agencies have long known, such governments are often willing to exchange reform for aid. Imposing economic reforms without parallel political reforms leaves the political system in a position to undermine or sabotage economic reform. The alternative to imposing liberal reform alone is to combine policy reform with institutional reform that promotes decentralization. But as noted, not all decentralizations are equal, and many will only worsen economic performance. To succeed, decentralization must devolve real policy and fiscal authority to subnational governments.

(c) *Decentralizing one step ahead*

The Chinese case suggests another important strategy for implementing top-down decentralization. Many developing countries face strong resistance to decentralization, in part because it involves change and not everyone benefits from that change. Others may be uncertain about whether benefits will truly emerge from decentralization, for example because local governments currently exhibit little competence or are highly corrupt. Indeed, poorly designed decentralization has made things worse for a large majority in some countries; for example, due to soft budget constraints or to mismatches in responsibility and resources for subnational governments.

In many developing countries, an across-the-board decentralization may therefore be problematic. The political and economic situation of some localities is such that greater freedom will result not in greater responsiveness to local citizen welfare, but instead greater authority and resources allow



local officials to create a larger scope for the system of local rents and corruption (Haggard & Webb, 2004).

Decentralization in a series of steps provides an alternative to across-the-board decentralization. The idea is first to identify one (or a small number of) province or region that is most likely to succeed in fostering local economic growth; and then to design decentralization so that this province obtains new authority, incentives, and resources to reform “one step ahead,” to use the Chinese term. The purpose of this strategy is to create a demonstration effect that decentralization can work in this country.

The Chinese successfully employed this strategy, allowing Guangdong Province to reform one step ahead. Many other provinces were skeptical of reform, and used their increased powers to maintain or even reinforce the traditional system. But Guangdong’s quick success won converts around the country, and even some of the most traditional provinces embraced reform. For example, Heilongjiang Province reacted to Guangdong’s market reforms by increasing the standard subsidies of the socialist system. Yet Guangdong’s reforms lowered the market prices of the same goods below the subsidized price. Because Heilongjiang accomplished the same result at great fiscal cost, fiscal incentives led its leaders to dismantle their expensive subsidies and imitate Guangdong (see Montinola *et al.*, 1995).

A similar, one step ahead strategy has emerged in a de facto way in Mexico with the areas seeking to integrate with the US economy, and to a lesser degree, in India. In Mexico, the center actively sought to discourage this independent movement from below (as we illustrated above in the discussion of the tragic brilliance mechanism), but could not prevent it. Many of the export-localities wrestled political control from the dominant party, the PRI, in order to improve the delivery of local services necessary to foster the light export industry developing in Northern Mexico.

Although the central authorities punished these areas with a marked decline in revenue transfers, the localities made up the revenue deficit by removing corruption—the PRI used their control of local utilities to pad the labor budget by mailing money to supporters throughout Mexico—and by charging user fees for improved local services (Rodriguez, 1995 and Rodriguez & Ward, 1995). As Rodriguez (1995, p. 166) suggests, “Over the course of only a few years, the ratio of state to local revenues... changed from around 70% state funding to over 70% local funding.” Citizens and firms willingly paid user fees for reliable, valued services, such as solid waste disposal, water, and road maintenance.

Part of the reason this system works is the high local demand for more efficient services necessary to integrate the economy with the US. The success of the first two municipalities to attempt this strategy, Ciudad Juarez and Chihuahua in 1983, created the demonstration effect. By the mid-1990s, most of the larger cities in Mexico were governed by the opposition.

## 6. CONCLUSIONS

This essay surveys a range of new SGFF research, focusing on a set of related topics involving political decentralization. The hallmark of second generation models is that they trace the implications of incentives created by political and fiscal institutions. This work provides a series of natural extensions of first generation models. FGFF models assume policy choice by benevolent social planners. The normative component of SGFF models studies how to devise political and fiscal institutions to align the incentives of political officials with citizens so as to approximate the FGFF idea.

This paper uses SGFF approaches to study several related questions involving the political economy of fiscal federalism relevant for traditional issues in fiscal federalism. How do various forms of fiscal federalism work in the presence of political officials who, rather than being benevolent social planners, face various forms of political incentives?

The paper discusses four sets of positive models. It begins with theoretical approaches to self-enforcing federalism, that is, to the question of how federal systems are held together given various tendencies for federal systems to become centralized or fall apart. This discussion highlights the role of political parties and of coordination by subnational governments against the center when the center encroaches on their powers. Nonetheless, not all federal systems are stable: some become centralized states (such as Mexico and India) while others fall apart (as in the US under the Articles of Confederation or Yugoslavia after the collapse of socialism).

The next topic concerns positive models of the assignment problem. In contrast to the huge FGFF literature on, we have only a handful of recent models attempting to explain how governments allocate authority over public goods provisions in practice. These models generally exhibit political impediments to the efficient assignment of authority.

The paper then turns to the issue of how specific types of political institutions, such as democracy, interact with decentralized systems. This section reveals several problems with sustaining democracy in developing countries and then shows how decentralization can mitigate some of them. This section also discusses the tragic brilliance model, which shows how an authoritarian central government can manipulate the fiscal system to bind citizens who oppose it to take actions in support of the government.

Finally, the paper studies various forms of political impediments to economic growth, again highlighting the interaction with decentralization. In particular, this section discusses normative issues showing how decentralization has the potential to overcome political predation. It also presents some suggestions about how to implement decentralization in an environment of some or considerable political opposition to federalism. In short, SGFF approaches do not completely dispense with normative issues. Rather, they raise new ones of equal interest to those studied in FGFF.

Two general themes emerge from this paper. First, each of the discussions reveal various political impediments to the efficient provision of public goods in the context of developing countries.

Second, various political forces promote centralization in developing countries. As discussed in Section 4, developing countries with distributed violence potential use policies and privileges to create rents that go to the powerful so that they have an incentive to cooperate rather than fight. Decentralization limits the ability of the center to distribute rents and thus makes the country more vulnerable to violence. Political officials at the central government level therefore have incentives to centralize. To the extent that FGFF models of taxation correctly show that the central government can tax more efficiently than subnational governments, the central government has both greater fiscal power than subnational governments as well as the ability to buyout subnational government officials in support of centralization (see Diaz-Cayeros, 2006 showing how this happened in post-WWII Mexico). Section 4 discussed how international efforts to promote democracy tend to focus largely on the government. The absence of attention to the subnational governments implicitly promotes centralization. Democratization of this form therefore raises the stakes of national politics, so it fails the limit condition and is less stable. Finally, the tragic brilliance mechanism also fosters centralization: the larger the

discretionary resources available to the center, the greater the center's ability to manipulate citizens to support it. In sum, sev-

eral separate sources of political incentives favor centralization in the context of developing countries.

## NOTES

1. Oates (2005) and Weingast (2009) provide surveys of SGFF ideas, although many SGFF ideas have a long history (see, e.g., Brennan & Buchanan, 1980; Inman & Rubinfeld, 1997a, 1997b; Wicksell, 1896). As Hatfield (2006) puts it, "Economic policy is not decided by benevolent social planners, but by government officials, usually with at least one eye to their reelection prospects".
2. Weingast (2009) focuses on applications of SGFF to fiscal issues.
3. Bland (2006) surveys this literature. See also Dillinger and Webb (1999), Garman, Haggard, and Willis (2000), and Stepan (2004).
4. See, for example, Filippov, Ordeshook, and Shvetsova (2003), Chhibber and Kollman (2004), Dillinger and Webb (1999), Enikolopov and Zhuravskaya (2002), Garman *et al.* (2000), Rodden (2006), Rodden and Wibbles (2002), and Tommasi, Jones, and Sanguinetti (2000). Volden (2004) traces the evolution of Riker's views on federalism.
5. Bednar (2009) and de Figueiredo and Weingast (2005) provide game theory models to study institutionalized autonomy, emphasizing the importance of states and the center using trigger strategies to police one another. Bednar emphasizes the importance of the center's policing the states, for example, with respect to the common market constraint. De Figueiredo and Weingast emphasize a balance between the center's policing the states and the states' collective ability to police the center from abusing its authority. Madison referred to this latter mechanism in Federalist 46, where he noted that potential abuses by the center would sound the alarm among the states and cause them to react in concert to prevent center abuse.
6. Standard works on the formation of party politics in India reflect this logic; see e.g., Weiner (1967).
7. Filippov *et al.* (2003) further argue that national electoral rules directly affect the degree of cooperation in federal systems. Some rules are more conducive to cooperation than others.
8. Koethenbueger and Lockwood (2010) provide a related work.
9. Riker (1982) provides a systematic analysis of these two aspects of democracy, emphasizing the importance of the second. Persson and Tabellini (2000) provide the most comprehensive analysis of electoral incentives, accountability, and responsiveness of electoral and political institutions; see also Besley (2006).
10. Przeworski's figures are in 1985 purchasing parity dollars. Moreover, for several reasons, these estimates should be taken as indicative. The data are necessarily derived from post-WWII history, so there is no event like the Great Depression in whose wake many democracies failed.
11. This subsection draws on North, Wallis, and Weingast (2009) and North, Wallis, Webb, and Weingast (2012).
12. Besley (2006) and Persson and Tabellini (2000) study the control of executive moral hazard, showing that the absence of constraints is inefficient.
13. Consider some of the sources of violence in Mexico, which has been relatively coup-free in comparison with the rest of Latin America. Labor unions have the power to disrupt; and have at times disrupted states attempting policies that unions dislike. Poor peasants have revolted at times (for example, in Chiapas). The state owned oil company, PEMEX, has what amounts to a private army, limiting the ability to reform this institution. Most recently, drug lords pose a new threat of violence.
14. Other prominent works considering the sequencing of democratization include Falleti (2005, pp. 52–60) and Linz and Stepan (1992), Linz and Stepan (1996, chap. 6).
15. Siegle (2006) and Treisman (2007, chap. 10) survey this literature.
16. Some of the transfers were by formula, but a large portion of it was discretionary, especially for local governments (Careaga & Weingast, 2003).
17. Indeed, in a classic study, Oates (1985) showed that poorer countries are on average more centralized than richer ones. North *et al.* (2009, table 1.4) provide similar evidence.
18. This discussion analyzes the tragic brilliance mechanism from the standpoint of democracy. But the tragic brilliance can also be analyzed as a patron-clientele exchange system in other regime types. The discussion above emphasized one side of this exchange, elections as a means of political control. The other side of this coin, however, is that, the mechanism requires that patrons deliver the goods. Seen in this light, the mechanism is a partially reciprocal one, if asymmetrical. The mechanism can therefore be interpreted as the means by which both sides of the patron-clientele relationship make a credible commitment to the exchange (see, for example, Chabal and Daloz's, 1999 study of patron-client relations in Africa). The new insight of the tragic brilliance approach is that patrons can create relationships with clientele even if the latter are worse off on average from the relationship.
19. The exercise of arbitrary power was the focus of many early modern theorists studying the dilemma's facing their societies as they were developing (e.g., 17th century England); including Harrington (1656), Locke (1689), and Montesquieu (1748).
20. The Chinese system is based on provincial revenue collection. The more common centralized revenue collection systems can use the same type of arrangements by keeping track of revenue collection by province.

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