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Bailouts, Budget Constraints, and Leviathans: Comparative Federalism and Lessons from the Early United States

Erik Wibbels

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BAILOUTS, BUDGET CONSTRAINTS, AND LEVIATHANS
Comparative Federalism and Lessons From the Early United States

ERIK WIBBELS
University of Washington

Recent research on federations, particularly in the developing world, emphasizes the importance of hard budget constraints and a strong central government to attenuate intergovernmental economic conflicts. Such research fails on two counts. First, it does not explain how hard budget constraints emerge or become self-enforcing. Second, it does not take into account the insight of the market-preserving federalism literature that central governments strong enough to impose restraint on regions are likely too powerful to be checked in a manner consistent with the long-term health of markets. Unfortunately, the market-preserving federalism literature itself provides little insight into how to move from a market-distorting to a market-preserving equilibrium. This article answers these theoretical shortcomings with reference to the evolution of political competition at the regional level and the representation of those regions at the national level. More specifically, whereas regional competition determines the subnational demand for soft budget constraints, the coalition of those regions at the national level determines the likelihood of their provision. Empirically, the research relies on a case study of the state debt crisis of the 1840s when the United States made a definitive movement toward market-preserving federalism.

Keywords: *market-preserving federalism; comparative federalism; hard budget constraints*

Comparative federalism is a booming industry. From research on the emergent federal characteristics of the European Union (Sbragia, 1992), to the consolidation of the Russian Federation (Solnick, 2000; Stoner-Weiss, 1997; Treisman, 1999), to role of state debt in Brazil's intergovern-

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mental struggles (Stepan, 2000), to the state-level dynamics which have played a significant role in Mexico's democratization (Beer, 2001; Rodríguez, 1997), federal politics is no longer the monopoly of a handful of scholars focused on a few Organization for Economic Cooperation and Development (OECD) nations. As the theoretical and empirical scope of research on comparative federalism has expanded, one of the most intriguing findings has been the degree to which federal politics and finance can generate economic problems. From the privatization of state-owned enterprises (Armijo & Jha, 2000) to macroeconomics (Rodden, 2002a; Treisman, 2000; Wibbels, 2000), politically insulated subnational officials seem to generate important policy distortions that complicate these federations' adjustment to the demands of an integrating international economy. Such findings stand in stark contrast to the traditional understanding of federalism as market-preserving that one finds in research by political scientists (Weingast, 1995) and economists (Oates, 1972).

Despite the fact that scholars of comparative federalism are conducting research in remarkably diverse national contexts, they are increasingly united in their prescription for the economic complications of some federations. Almost without fail, the solution is deigned to be the hardening of "soft budget constraints," or various practices by which regional governments export the costs of poor economic policies to the rest of the nation (Poterba, 1996; Poterba & von Hagen, 1999; Rodden, Eskeland, & Litvack, 2002). These practices politicize intergovernmental finance, encourage regional politicians to behave in economically imprudent manners, and weaken central governments that are subject to predatory behavior by subnational politicians. Because researchers commonly assume national governments (and chief executives, in particular) to be the sole actors concerned with the overall health of the economy, federations supposedly need a strong central government capable of hardening budget constraints by imposing debt limits on regional governments, designing fiscal transfer systems that discourage regional dependence on the center, and committing to a policy of no bailouts regardless of regional economic troubles. In contexts such as Russia (Ordeshook, 1996; Ordeshook & Shevtsova, 1997) and Brazil (Mainwaring, 1999; Samuels, 2000; Stepan, 2000), centralized, national parties are a favorite disciplining mechanism. Thanks to strong, national parties, the reform of soft budget constraints will supposedly force subnational politicians to internalize the costs of their policies and prevent them from complicating economic policy.

Although this new research on comparative federalism has made considerable contributions, particularly in problematizing the supposed affinity

between markets and federalism, this article suggests that the "hard budget constraints by a strong center" solution is misplaced. First, it is inconsistent with the market-preserving literature, which recognizes that a strong center is likely inconsistent with markets (Oates, 1972; Weingast, 1995). That body of research has long recognized that a center strong enough to impose constraints is likely too strong to be checked by the regions in a manner consistent with the long-term health of markets. Second, the research fails to endogenize the demand for soft budget constraints by regional politicians. Deficient intergovernmental institutions are assumed to generate common incentives for all regions in a federal system. Nevertheless, the degree to which regions overspend, overborrow, and rally for central bailouts varies significantly within federations. A focus on the softness of budget constraints provides few insights into why this is the case. Third and finally, much of the research is technocratic in failing to recognize that the hardening of budget constraints is inherently political. In many cases, federal finance is a fundamental feature of existing federal contracts. Thus, the reform of budget constraints requires the acquiescence of regional governments themselves, which introduces intense collective action problems. To be binding on national and regional governments, hard budget constraints must be consistent with the political interests of those governments. Indeed, recent decades are replete with examples of formal hard budget rules that have proven politically unsustainable. The challenge, therefore, is to understand how self-enforcing budget constraints emerge.

This research suggests that far from being rooted primarily in national politics, hard budget constraints evolve out of political considerations at the regional level and the manner in which regional interests are represented at the national level. Put simply, hard budget constraints become binding on national and regional governments when enough regions are opposed to federal bailouts that their representation at the national level is sufficient to ensure that their preferences shape federal policy. When that is the case, two questions take on central importance: Why do some regions rally for the federal bailouts that make for soft budget constraints? and What is the relative influence of pro- and antisoft budget constraint regions in national politics? Building on research by Alt, Lassen, and Skilling (2001a), De Figueiredo (2002), Ferejohn (1999), and others, I suggest that the answer to the first question depends primarily on levels of regional electoral competition. Regional governments in competitive contexts will pay greater attention to public goods provision, be less likely to overspend, and therefore less likely to lobby for bailouts from the center. The answer to the second question depends on the number of regions opposed (and in favor) of bailouts and how

those regions are represented at the national level. When enough regions are fiscally healthy, it becomes impossible for proposals to initiate federal bailouts to pass national legislatures—healthy regions will want nothing to do with subsidizing poor performers. In focusing on the supply of and demand for hard budget constraints, these two factors provide insight into the conditions for the emergence of market-preserving federalism.

This theoretical argument is explored in the context of the U.S. state debt crisis of the 1840s. That crisis is comparatively interesting for a number of reasons. First, the scope of the debt crisis mirrors recent regional calamities in Argentina, Brazil, and elsewhere. Second, as in numerous contemporary federations, many states in the 1840s United States rallied for federal bailouts of their debts. Nevertheless, despite the fact that the national party system was quite weak and formal fiscal rules limiting state indebtedness did not yet exist, a strong coalition of politically competitive (and hence fiscally healthy) states precluded the federal assumption of state debts. This precedent is noteworthy, for it established the lasting expectation that the federal government was not the lender of last resort for the states, thereby ensuring that capital markets would assess the borrowing capacity of the states on their own merits. It is exactly this relatively rare "no bailout" commitment which makes the intergovernmental battles in the United States of the 1840s so comparatively and analytically intriguing, because it is so desperately lacking in many contemporary federations.

This emphasis on the importance of regional politics in shaping the hardness of budget constraints has important implications. Theoretically, it helps reorient the burgeoning literature in comparative federalism away from formal budget rules to the politics that underpin intergovernmental conflict over budget constraints. Although most research has emphasized the role of intergovernmental institutions in fostering the supply of hard budget constraints, this article suggests the need to focus on demand, which is rooted largely in subnational politics. Additionally, this research addresses shortcomings of the market-preserving federalism and hard budget constraint literatures, which specify neither how hard budget constraints become politically feasible nor how to move from soft to hard budget constraints. In emphasizing the role of regional-level competition and the national-level representation of regions, this research endogenizes the emergence and sustainability of hard budget constraints. Finally, with respect to policy, these findings suggest efforts should be made to strengthen subnational democracies rather than formally closing soft budget constraints. Despite being in vogue, formal budget rules are unlikely to work when inconsistent with underlying federal politics.

FEDERALISM, ECONOMICS, AND THE CHALLENGE OF HARD BUDGET CONSTRAINTS

The economic problems associated with many federations in the developing world are now well known and require only brief description here. Broadly speaking, economic policy in these nations is subject to common pool problems as regional governments face various institutions and practices which allow them to export the costs of their economic decisions to other parts of the federation. Whatever their form, soft budget constraints (as such institutions and practices are known) allow regional governments to overspend without eventually facing the associated costs (Oates, 1972). Under soft budget constraints, regional governments are able to petition the central government for ex post resources through ad hoc transfers, state-owned banks, state-owned enterprises, and so forth, which obviate the need for taxing their own citizens.[1] As a result, the common pool of national fiscal resources become the subject of intense political competition among the regions, all of whom have incentives to procure additional federal bailouts at the expense of the federation as a whole (Cai & Treisman, 2001; Rodden et al., 2002). The end result is a weak center with a compromised capacity to manage crucial economic policies and profligate regions with incentives to overspend.

The empirical record with regard to soft budget constraints is dizzyingly complex. In Brazil, states have relied on state-owned banks for deficit financing. In a series of bailouts spanning two decades, the federal government has assumed those debts by rescuing failing banks (Montero, 2001; Samuels, 2002). In Argentina, the majority of small, overrepresented provinces have benefited from irregular transfers, debt assumption by the national government, and, up until the early 1990s, an avenue for exporting overspending via provincially owned banks (Gibson & Calvo, 2000; Tommasi, 2002). In India, the poorest state fiscal performers benefit from a fiscal system that rewards deficits with stop-gap transfers (Rao, 1997; Rao & Singh 2000), and state governments of the same party as the center attract discretionary federal loans (Khemani, 2001). Many Indian states have also used their electricity companies as a source of off-budget revenues (Armijo & Jha, 2000). In Nigeria, federal loans to state governments are periodically written off (Mered, 1997), and federal transfers are subject to political manipulation (Suberu,

1. The disconnect between taxing and spending is also expected to make it harder for citizens to assess the costs and benefits associated with public goods provided by various levels of government.

2001). In Russia, Moscow rewards the regions with the most vociferous separatist claims with preferential fiscal agreements (Treisman, 1999). In their various forms, these soft budget constraints exacerbate fiscal pressures on the general government (Rodden & Wibbels, 2002), increase inflation as central governments monetize regional debts (Treisman, 2000), foster spending on regional clientelist networks (Remmer & Wibbels, 2000), and complicate exchange rate policy (Woodruff, 1999).

What is notable about this emergent comparative federalism literature is how it challenges longstanding assumptions about the affinity between decentralized governance and economic performance. According to this research tradition, captured most concisely in the market-preserving federalism literature (Montinola, Qian, & Weingast, 1995; Qian & Roland, 1999; Weingast, 1995), the economic benefits of federalism are twofold. First, regional units serve as a powerful constraint on central governments. Whereas unchecked central officials have incentives to self-interestedly manipulate economic policy or expand the scope of the national government, regional governments check the federal government and ensure property rights. Second, competition among regions for mobile tax bases ensures the efficient delivery of public services consistent with the demands of diverse constituencies.

Research on federations outside of the United States shows just how rare the conditions for market-preserving federalism are and, in doing so, has generated a flurry of proposals as to how to solve the coordination problems vis-à-vis economic policy. The preponderance of such research suggests that national governments simply need to harden soft budget constraints. The mounting literature on the importance of "good" budgetary institutions for helping central officials make the commitment to not bail out regional governments is voluminous.[2] With specific respect to federalism, researchers suggest the importance of minimizing intergovernmental transfers to regional governments (Rodden, 2002a; Wildasin, 1997) and ending national bailouts of highly indebted regions (Shah, 1994). At the regional level, analysts point to the importance of balanced budget laws (Alt & Lowry, 1994), constitutional limitations on borrowing and indebtedness (Poterba, 1996), and caps on expenditure growth (Alesina & Bayoumi, 1996) as useful formal checks on the capacity of regional politicians to generate the imbalances likely to foster bailout demands.

Although the empirical evidence supporting the claim that formal budget rules matter is strong, much of the research suffers from a number of short-

2. For a good review of the literature, see Alesina and Perotti (1999).

comings. First, it fails to explain why there is such significant variation in the degree to which regions within federations exploit soft budget constraints. In emphasizing the vulnerability of central governments vis-à-vis soft budget constraints, the research tends to suggest that all regions abuse federal governments equally. Yet as the examination of the U.S. case below shows, the demand for soft budget constraints varies significantly across regions. Second, it fails to appreciate the lesson from the waves of failed intergovernmental financial reform in federations around the world in recent decades. In many of the federations with soft budget constraints outlined above, formal rules aimed at hardening budget constraints are simply evaded or ignored. Indeed, in many cases, institutional reforms were designed with evasion in mind.[3] Such cases suggest how important the political underpinnings are to the sustainability of hard budget constraints. Third and finally, much of this research fails to appreciate that soft budget constraints are endogenous to politics.[4] At the regional level, the U.S. case examined below (and related research in other contexts) suggests that governmental transparency, balanced budget laws, and other institutions at the heart of recommendations to harden budget constraints are almost certainly a function of competitive electoral environments where politicians have incentives to generate such institutions. As such, the problem with fashionable technocratic answers to the intergovernmental fiscal challenges raised by this research is that they tend to ignore the politics underpinning the emergence and enforcement of hard budget constraints.

Indeed, examples of significant reforms to federations in recent decades suggest that addressing soft budget constraints is politically difficult and rarely central to broader federal reforms. In the Russian context, the economic collapse of the Soviet Union led to a de facto decentralization of revenue collection to regional governments, which have fiscally strangled the central government for most of the post-Soviet era.[5] A similar process took place in Brazil where the Constituent Assembly constitutionalized significant

3. See Gómez (2000) on the series of reforms to intergovernmental finance in Brazil which, despite formal constraints on state indebtedness, have been flaunted repeatedly.

4. For an exception, see Poterba and von Hagen (1999).

5. Stoner-Weiss (1997) explains that

> the volatile and unpredictable post-Soviet environment pushed still weak regional political institutions to the limit. . . . At the same time, the federal government in Moscow divested itself of costly policy responsibilities (health, social welfare, and consistent support of the economy) and foisted these on newly established, and poorly financed, regional governments. . . . Not unexpectedly, conflicts over scarce regional government resources became especially sharp in many parts of provincial Russia. (p. 32)

decentralization of revenues to the states without any corresponding expenditure responsibilities, and placed the Senate in charge of many aspects of state-level indebtedness (de Souza, 1997; Stepan, 2000). The result has been a propensity for state debt bailouts and a central government with difficulties managing the macroeconomy. In both cases, the broader issues associated with regime transitions swamped considerations of soft budget constraints.

Although instances of less profound reform, Colombian and Veneuzuelan central officials initiated substantial fiscal decentralization in an attempt to rescue the declining legitimacy of traditional regimes. Both cases, for distinct reasons, have subsequently recentralized—in Colombia due to fiscal concerns associated with departmental spending, and in Venezuela thanks to Hugo Chavez's authoritarian tendencies. The Argentine case in the 1990s is the only one where intergovernmental fiscal reforms were designed explicitly to close soft budget constraints. Some of those reforms, however, have proven quite transient, and even President Menem during his decree-happy first term was unable to change the fundamental nature of that nation's soft budget constraints (Tommasi, 2002). As a result, provincial fiscal policy has come to play a central role in that nation's unfolding economic crisis.

These cases suggest a number of important points. First and most important, when considering the reform of soft budget constraints, the political latitude of the federal government is constrained by regional politics. Despite a plethora of instances in which central authorities were well aware of the negative implications of soft budget constraints, they remained unable to push through reforms exactly because enough regions benefited from the status quo to veto policy change. As a result, soft budget constraints are incredibly sticky. Second, the reform of fiscal institutions usually happens in the context of broader transitions. In the Brazilian and Russian cases, those transitions were from authoritarianism to democracy. In most of the other cases, reform occurred as a result of attempts to reinvigorate moribund democracies by decentralizing. In all of these cases, the conditions surrounding the larger reform projects precluded serious consideration of budget constraints. The conclusion is not terribly promising: It seems that only when regimes are in crisis do we see the political obstacles to reforming intergovernmental finance overcome, but exactly because of the crisis, soft budget constraints warrant little attention. As such, we know very little regarding the political foundations for sustainable hard budget constraints.

STRONG CENTERS, NATIONAL PARTIES, AND THE PROVISION OF HARD BUDGET CONSTRAINTS

Herein lay the great challenge for the market-preserving theory of federalism: how to move from soft to hard budget constraints. Increasingly, researchers find a political solution to soft budget constraints in increasing the authority of the central government. The logic behind strengthening the center is clear. Intense collective action problems preclude either provincial governments or national legislatures from mounting a unified attack on bailout mechanisms. National executives, on the other hand, are elected by national constituencies and judged on the basis of national economic performance rather than more parochial, regional concerns. As such, the sole actor with the incentives to harden budget constraints is the chief executive.[6] The obvious means to achieving market-preserving federalism, it would seem, would be to strengthen the most market-friendly actor in the federation.

It is analyses such as these which contribute to the widespread perception that many developing federations suffer from an overly weak center subject to predatory behavior by regions. In a broad survey of decentralization and soft budget constraints, Rodden, Eskeland, and Litvack (2002) suggest that "the national government and its institutions might be weak—lacking instruments, guts, or both—in its ability to enforce loan contracts" (p. 12). Stepan (2000) bemoans the fact that Brazil's constitution gives the central government so little macroeconomic authority vis-à-vis state governors. Likewise, Goorha (2001), Solnick (2000), and others lament the weakness of the central government vis-à-vis regional bosses. In a comparison of China and Russia, Blanchard and Shleifer (2000) go so far as to argue that China's political centralization has been the defining feature of its robust growth. This contrasts with Russia, where

> the central government has been neither strong enough to impose its views, nor strong enough to set clear rules about the sharing of the proceeds of growth. As a result, local governments have had few incentives either to resist capture or to rein in competition for rents. (Blanchard & Shleifer, 2000, p. 2)

6. Arguments in favor of centralization are made in the public finance literature, which emphasizes the importance of centralizing budgetary processes, and the market reform literature, which suggests that policy makers can only bear the short-term costs of the transition to markets when they are insulated from social actors.

Even in Mexico, historically one of the most centralized federations in the world, Amieva-Huerta (1997) argues that "the federal government has had difficulty imposing financial discipline on the states" (p. 591).

Many researchers emphasize the importance of increasing the national orientation and discipline of party systems as a means to empower central governments. This emphasis is not new—the study of federalism has long focused on the role of parties in mediating relationships across levels of government (Grodzins, 1960; Riker, 1964). More recently, research on Russia (Ordeshook, 1996; Ordeshook & Shevtsova, 1997), various Latin American federations (Garman, Haggard, & Willis, 2001; Stepan, 2000), and a handful of OECD federations (Rodden 2002b) has refocused attention on the importance of party systems in shaping the relative balance of power between national and subnational decision makers. The conventional wisdom holds that where national party leaders can discipline party members at various levels of government, it becomes easier to implement coherent, unified policies that transcend jurisdictional divisions (Wibbels, 2001). By extension, the reform of soft budget constraints and imposition of economic discipline becomes easier the greater the influence of national partisans over their subnational counterparts. These observations are often accompanied by recommendations for centralizing party influence.[7]

Many of these analyses emerge out of research on the problems associated with highly decentralized federations such as Brazil, Russia, and, increasingly, India.[8] The empirical record of more centralized federations should give pause, however, to suggestions that a stronger center is an appropriate solution to soft budget constraints. For if Russia and Brazil underscore the dangers of weakly integrating party systems, any number of other federal cases suggest the danger of overcentralizing authority. The highly centralized Venezuelan and Mexican party systems, for instance, proved unable to negotiate the dual demands of market reform and democratization percolating from the subnational level (Coppedge, 1994). Even the Argentine and Indian cases, although less extreme in their degrees of party system centralization,

7. Specific proposals include concurrent elections to foster coat-tail effects (Shugart & Carey, 1992), national control over party nominations (Samuels, 2000), and high barriers to representation to limit party system fragmentation (Mainwaring, 1999).

8. See Samuels (2000) and Mainwaring (1999) on Stepan (2000) on how Brazil's system of open list proportional representation, low threshold for representation, and high district magnitudes combine with the Brazilian president's weak partisan powers to create an undisciplined party system that emphasizes state-centric issues at the expense of national ones. Likewise, Ordeshook and Shevtsova (1997) emphasize Russia as a case where political parties provide few incentives for regional and central authorities to coordinate policies, and Kohli (1990) suggests that the breakdown of the Congress Party's hegemonic role in Indian politics has brought with it the proliferation of particularistic claims in that nation.

suggest the dangers of concentrating authority within parties. In Argentina, the powerful position of Carlos Menem within the Peronist party encouraged him to threaten the autonomy of provincial governments in support of a radical economic reform strategy, particularly through the first half of the 1990s (Wibbels, 2001). Although successful economically in the short term, the concentration of authority served as an irresistible temptation to govern self-consciously from the center, which proved unsustainable beyond Menem's first term in office. Likewise, the cult of personality characteristic of India's Congress Party encouraged a degree of centralization problematic for that nation in the 1960s and 1970s. Mehta (1997) explains that "both Indira and Rajiv Gandhi cemented their electoral coalitions through a mixture of populism and authoritarianism. . . . This approach systematically weakened the institutional machinery of the state, in particular its federal structure and judiciary" (p. 58).[9] Finally, Nigeria presents the starkest example of how inconsistent the centralizing logic is with functioning markets. Emphasizing the dangers of overcentralization, Suberu (2001) points to "the continued intensity of distributive contention (as opposed to productive accumulation) in the Nigerian federation as the country's constituent governments and segments struggle relentlessly for the center's abundant financial resources and distributive largesse" (p. 2).[10] Far from fostering subnational economic rationality, centralization can provide a highly attractive target for bailout claims.

In all of these cases, the excess of centralization has proven as problematic as the lack thereof in Brazil and Russia. Surplus of party discipline, hyper-presidentialism, and overcommitment to national (as opposed to regional) concerns in the former cases replace party fragmentation and strong federalism in the latter. Armijo and Jha (2000) emphasize this point in a study of the intergovernmental politics associated with privatization in Brazil and India: "Often a greater willingness by the centre to respect the perceptions and distributions of costs and benefits *as experienced by the state government* . . . can help to resolve these conflicts" (p. 128). An excessive emphasis on the importance of central governments imposing hard budget constraints on regions ignores this important point. Indeed, the market-preserving federalism literature clearly warns that formal fiscal constraints imposed by strong centers are

9. Indeed, multiple studies suggest that the imposition of presidential rule (Indian prime ministers have the constitutional authority to dismiss state governments) has been used for strikingly partisan motives (Khemani, 2001).

10. Suberu (2001) goes on to argue that

> the impact of this "ethno-distributive" approach to federalism has not been to spur local development efforts but to intensify the reliance of constituent segments and governments on central largesse in a way that has harmed rather than fostered the development of genuine federal relationships. (p. 7)

problematic. Weingast (1995) writes that the answer to intergovernmental commitment problems "cannot be simply a written rule, for rules can be changed, avoided, or ignored" and that "a sustainable system of federalism . . . must prevent the central government's ability to overawe the lower governments" (pp. 3-4). In other words, sustainable hard budget constraints rest on a balance between national and regional governments. Given that the burden of reforming soft budget constraints seem most likely to fall on chief executives, however, one is left with a rather sticky dilemma: How is a center strong enough to impose reforms to be prevented from going too far and displaying the leviathan-like characteristics that market-preserving federalism is so concerned with? As the following theoretical argument suggests, the emphasis on strong central governments is misplaced. Hard budget constraints are self-reinforcing when they reflect the interests of politicians at both the national and regional levels.

THE FEDERAL FOUNDATIONS OF HARD BUDGET CONSTRAINTS

This research suggests that there are two questions central to understanding the emergence and sustainability of hard budget constraints: First, why do some regions overspend and rally for bailouts whereas others do not? And second, what is the size of the national coalition of regions for and against national bailouts and soft budget constraints? The answer to the first question determines the regional demand for bailouts and soft budget constraints. The answer to the second question fundamentally informs the supply of those bailouts by the central government.

I suggest that the answer to the first question depends largely on the level of regional electoral competition. Despite the longstanding suggestion that budgetary politics in democratic contexts suffer from a deficit bias (Buchanan & Wagner, 1977; Weingast, Shepsle, & Johnson, 1981), recent research suggests a number of reasons that electoral competition is likely to constrain the abuse of public resources (Alt et al., 2001a; De Figueiredo, 2002; Ferejohn, 1999). First, where incumbency rotates regularly and the outcome of future elections is uncertain, out parties are pointedly concerned with current debt assumption as any future government of their own will be saddled with servicing that debt. While current deficits further the spending goals of the in party, the debt payments will detract from the out party's capacity to forward its objectives in the future. Second, incumbents also have incentives to be wary of debt assumption. As Alt et al. (2001a) explain,

> If the incumbent believes that it will be replaced by another party with different preferences, and which may impose the burden of paying down the debt on it, the incumbent will be less inclined to raise debt. The incumbent's knowledge that it may not be in power in the next period, and that the policy changes will be contingent on its actions in the first period will induce policy compromise. (p. 7)

Thus, in competitive contexts, in parties and out parties have incentives to cooperate in a constrained use of public resources. Third and finally, the electorate also provides incentives for budget balance in contentious political environments. Ferejohn (1999) and English (1996) suggest that where citizens believe that officials will waste or steal fiscal resources, they are less likely to allocate revenue to politicians.[11] Thus, public officials in competitive contexts are induced to make their fiscal decisions transparent. Absent competitive checks and balances, political systems are likely to have more waste and embezzlement, thereby limiting access to the fiscal resources which cushion budgets in hard times. Broadly speaking, these three factors combine to suggest that competitive politics serve to accentuate the fiscal shadow of the future, encouraging regional politicians to pay greater attention to public goods provision, overspend less, and therefore be less likely to lobby for bailouts from the center.

Of course, there are a number of factors likely to constrain the benefits of electoral competition. Consistent with the veto player literature, fragmented multipartyism is likely incompatible with fiscal austerity independent of the level of electoral competition. Indeed, recent research argues that political fragmentation—whether in the form of multiparty coalitions or partisan divisions between the executive and legislative branches—leads to slower fiscal adjustment to unexpected shocks and persistently higher budget deficits and public debts (Alesina & Perotti, 1995; Persson & Tabellini, 2001). The explosion of state-level multipartyism in Brazil, for instance, may help explain the growth of state deficits despite competitive elections. Similarly, where regional legislatures are elected by geographic constituencies, the beneficial effects of competition are likely mediated by the tendency toward log-rolling and pork-barreling (Weingast, Shepsle, & Johnson, 1981). That being the case, equally competitive regional politics in India and Argentina would produce less lobbying for bailouts in the former, where state legislatures are elected by proportional representation rather than geographic constituencies as in Argentina. I should emphasize, however, that these additional factors

11. In English's account, the result of perceived malfeasance is a resistance on the part of the electorate to fiscal surpluses.

are independent of the underlying level of electoral competitiveness—although they likely have a negative effect on the fiscal behavior of regional governments, they are best understood as intervening variables between the level of electoral competition and the fiscal behavior of regional governments. Indeed, empirical work in contexts as diverse as the former Soviet Union (Hellman, 1998), Latin America (Remmer, 1998), East Asia (Haggard, 2000), the contemporary U.S. states (Rogers & Rogers, 2000), and the OECD (Alt et al., 2001a, 2001b) supports the theoretical claim that reduced electoral competition increases the political abuses of public sector resources that are likely to lead to bailout claims.

If diverse levels of electoral competition influence which regions are likely to favor bailouts, the size of the regional coalitions for and against bailouts at the national level is important in determining the preferences of the national government—and hence the supply of soft budget constraints. The size of the coalitions at the national level depends on the ratio of regions with competitive elections and the method by which those regions are represented in the national policy-making process. This issue of national representation is of crucial importance because federal bailouts of regional governments (and the soft budget constraints they produce) are inherently redistributive—they involve taxing some regions and redistributing it to others. When the winners of soft budget constraints have significant institutional representation in the national policy-making process (via control over a majority of seats in the national legislature, for instance), the central government's interests are likely to favor bailouts. Indeed, where profligate regions control national senates, they are likely to have the means to obstruct national efforts at fiscal retrenchment and the political pull to successfully lobby for national bailouts. On the other hand, when the coalition of regions in a federation that is opposed to bailouts is larger than the coalition of profligate states, any requests for bailouts are unlikely to succeed at the national level—fiscally healthy provinces will resist subsidizing poor performers.

The prevalence of soft budget constraints in some federations is rooted in the fact that they inevitably provide specific benefits to regions with the political capacity to secure federal bailouts. That they can secure bailouts depends on how regions are represented at the national level. A number of factors underscore the importance of this issue. First, existing soft budget constraints are constitutionalized in many of the developing world's federal systems. From Argentina's fiscal labyrinth (Tommasi, 2002) to the role of Brazil's Senate in bailing out state debts (Samuels, 2002), constitutionalization provides a significant barrier to reform given the super-majorities generally necessary to alter constitutions. Second, this difficulty is exacerbated where national Senates are quite powerful and tend to overrepresent small and polit-

ically uncompetitive provinces (Sawers, 1996; Stepan, 2000). To the degree that these regions often benefit from fiscal resources raised in wealthier provinces, the majorities they hold in national legislative bodies tend to complicate attempts to reform soft budget constraints. Lastly, this problem of overrepresentation is exacerbated in many developing nations by sharp regional inequalities, where a small handful of regional economic engines stand in sharp contrast to the economic backwardness of most regions. This situation encourages majority coalitions of poor provinces to obstruct efforts to reform distortionary intergovernmental fiscal institutions. All told, these factors serve to exacerbate a problem at the heart of federal finance: The same minority that benefits from soft budget constraints is needed to support reforms of intergovernmental finance if their passage is to be assured. This challenge can only be overcome when enough states with sufficient electoral competition combine at the federal level, thus serving as an important check on the less competitive ones. Rather than relying on the imposition of economic rationality from the center, this is a dynamic whereby the regions effectively check each other, hence preventing dependence on the center and ensuring the political sustainability of hard budget constraints.

FEDERAL POLITICS AND HARD BUDGET CONSTRAINTS: THE U.S. STATE DEBT CRISIS OF THE 1840S

An examination of the U.S. state debt crisis of the 1840s offers analytical leverage on the issues discussed above for several reasons. First, this was a period of tremendous significance in U.S. public finance, much as the transitions to market-based economies are for many contemporary federations. As Grinath, Wallis, and Sylla (1997) explain, "The U.S. state defaults of the 1840s, an era of fiscal crisis following a decade of fiscal exuberance, were one of the most spectacular episodes in the history of American public finance" (p. 1).[12] As similar crises have struck the Argentine, Brazilian, Indian, and Russian regions in recent years, examining the historical record of a country that solved such a traumatic period with a market-based solution can add clarity to ongoing reform debates. Second, the 1840s was a period that threatened the emergence of soft budget constraints in the U.S. states. Indeed, budget constraints were not totally hard prior to the crisis: the federal government had assumed state debts on two previous instances (Garber,

12. One observer at the time described the crisis in these terms: "These seven years formed one of the most extraordinary financial periods—perhaps the most extraordinary one—the world has ever seen" (Curtis, 1844, p. 110).

1991),[13] excess federal revenue had produced ad hoc fiscal transfers to state governments (Ratchford, 1966, p. 85), states had access to finance through their own banks (Grinath et al., 1997, p. 32; Sylla, Legler, & Wallis, 1987), and some states printed scrip to pay creditors and public employees (Ratchford, 1966, p. 76).[14] Although there is debate regarding the degree to which these factors constituted soft budget constraints, they do suggest that the connection between electorates and the spending behavior of governments was somewhat tenuous.[15] Most important, the period saw a strong movement for the federal assumption of state debts, which would have represented a clear bailout. Had the move for federal assumption been successful, it would have established a precedent that led the United States down a path of soft budget constraints common to many contemporary federations. As Ratchford (1966) notes, "A second assumption would almost certainly have converted a precedent into a habit, the results of which are not pleasant to contemplate" (p. 104). Yet the debt crisis ended with a precedent that moved federal finance very clearly in the direction of market-based discipline. As such, the U.S. case can provide some insight into the process by which hard budget constraints are enforced and sustained.

The market-preserving resolution of the debt crisis underscores the centrality of state politics in shaping the demand for bailouts. During this period, despite the fact that the United States lacked strong national parties and the formal fiscal rules that constrain state spending today, opponents defeated the federal assumption of state debts. This precedent is noteworthy, for it established the lasting expectation that the federal government was not the lender of last resort for the states, thereby ensuring that capital markets would assess the borrowing capacity of the states on their own merits. This is not to say that states from this historical point onward always behaved in a fiscally prudent manner—some did not. Absent the failure of federal assumption, however, bond markets could not have punished state overspenders as credit-worthiness would in part come to reflect the fiscal position of the federal government.[16]

13. The national government had assumed the revolutionary war debts of states in 1790 and the debt of Washington, D.C., in 1836. See House Report No. 296 at 11 (1843) for a brief history of federal assumption of state debts up to the 1840s.

14. As Ratchford notes, this was unconstitutional under Article 1 Section 10 of the federal Constitution.

15. It is particularly difficult to assess the degree to which political actors expected the federal government to bail them out of troubles. Although British bankers assumed the good name of the federal government was behind state bonds (McGrane, 1935), there is not solid evidence one way or the other regarding the expectations of state politicians. Because the hardness of budget constraints depends in large part on the expectations of actors with respect to bailouts, it is very difficult to say definitively how hard budget constraints were in the lead up to the crisis.

In addition to ensuring that credit markets developed into the market preserving mechanism they did, the resolution of the crisis also clarified the division of economic responsibilities for voters who would be better able to hold the right level of government accountable should their states' finances collapse. This refusal to assume state debts carries comparative weight as it is this expectation of bailouts that plagues intergovernmental relations in so many contemporary federations. What the United States of the 1840s suggests is that a nationally critical mass of competitive electoral democracies at the state level are crucial for the development and enforcement of hard budget constraints and fundamental for the emergence of market-preserving federalism. Indeed, as the analysis below makes clear, many of the formal fiscal institutions associated with hard budget constraints (such as constitutional constraints on debt assumption) appeared after and as a result of the debt crisis and the failed movement for federal assumption.

The debt crisis of the 1840s has its roots in the 1820s and 1830s, when state governments assumed the responsibility of economic development by spending large sums on infrastructure projects, particularly railroads and canals (Goodrich, 1960; Sbragia, 1996). With few revenue streams in a political environment dominated by antitax sentiments, many states relied on various financing practices that weakened the link between electorates, expenditures, and indebtedness.[17] Indeed, Wallis (2002) refers to this as a period of taxless finance. Many states relied heavily on their own public banks for loans and other forms of finance. Indeed, above and beyond infrastructure, the most common purposes for borrowing was to establish state banks, which then served to finance development projects and other interests of many state governments (Sylla et al., 1987).[18] Thanks to the easy access to finance and the drive for internal improvements, many states accumulated impressive debt burdens (English, 1996; McGrane, 1935; Ratchford, 1966).

By the late 1830s, the aggressive expansion of public works, weak revenue bases, heavy debt burdens, and a crisis of confidence in European capital markets precipitated a debt crisis for many states.[19] Without access to new credit, partially completed transportation projects ground to a halt, state

16. It is worth noting that the findings regarding the contemporary capacity of state electorates to hold parties accountable for fiscal policy (Alt & Lowry, 1994; Lowry, Alt, & Ferree, 1998) would likely be impossible in the presence of ad hoc intergovernmental bailouts.

17. In addition to the schemes outlined below, state governments received significant revenue from the sale of public lands, the transfer of federal surpluses to the states, property taxes, and user fees for railroads and canals (once they were completed).

18. By 1837, there were 788 state banks (McGrane, 1935).

19. On the 1837 financial crisis, see McGrane (1935). On the 1939 depression, see Wallis (2001).

banks failed, and the heavily indebted states found themselves in the most serious fiscal crisis since the period immediately following the Revolutionary War. In 1820, the total indebtedness of the states was only $12.8 million. Two decades later that amount had increased by more than 1,300% to more than $170 million (Ratchford, 1966, p. 105). This crisis inspired nine state defaults, four partial repudiations of amounts owed, and a strong movement for the federal assumption of state debts (McGrane, 1935, pp. 21-61; Ratchford, 1966, pp. 73-104; Scott, 1893; Wallis, 2002) by the early 1840s.[20]

Federal assumption was attractive to many states for a number of reasons.[21] Proponents argued that the states could complete their internal improvement programs (themselves expected to provide a boon to state finances once concluded) if relieved of their debt burdens, the federal government could issue bonds at a much lower interest rate than those paid by the states, the federal government could use money raised from the sale of apparently limitless public lands to finance the bonds, and the political costs of direct taxation necessary to pay the debts were impossibly high. The argument for assumption was stated most clearly in a report by Rep. William Johnson of Maryland, Chair of the House Select Committee. The report makes quite clear the seriousness of the issue and is worth quoting at some length:

> They [the states] unite in the expression of one common opinion—that industry has greatly lost its reward; that property and wages have fallen greatly in value; that confidence is impaired between man and man; and that while they have the will, they have not the means or ability to discharge the annual exactions of direct taxes, which many of the States are being forced to levy, in order to meet their engagements and preserve their plighted faith. And they express the earnest conviction, that confidence will not be restored; that industry . . . will not thrive; that general prosperity will not return and abide; that the faith of many of the States will not be maintained, nor the General Government itself recover and sustain its former high credit and character, unless Congress extends its aid, and by prompt, decisive, and enlightened legislation rescues the people and the States from their present depressed and embarrassed condition. (H. R. Rep. No. 296 at 1, 1843)

20. The defaulting states were Mississippi, Arkansas, Indiana, Illinois, Maryland, Michigan, Pennsylvania, Louisiana, and the then-territory of Florida. The defaulters were Mississippi, Florida, Arkansas, and Michigan.

21. Note that the movement was led by Pennsylvania. See House Report No. 296 at 17-47 (1843), including "Memorial of Citizens of Western Pennsylvania," "Memorial of Inhabitants of Erie County, Pennsylvania," "Memorial of Citizens of Monongahela City, Pennsylvania," and so forth.

The proposed bailout would have required that the federal government issue $200 million worth of stock, which would be used for the relief of the states.[22] The funds were to be allocated among the states (and territories) on the basis of $1 million per senator and $651,982 for each representative. Assumption would have represented a quintessential bailout of state governments.

Despite the enthusiasm for assumption among some states and the leadership of the movement by one of the most powerful states in the nation (Pennsylvania), the plan failed. Why that was the case is not well established in the historical literature, though the opposition was vehement (House Report No. 296 at 559, 1843). In response to the above-mentioned report, for instance, John Quincy Adams introduced a resolution that any defaulting state that thereby involved itself in war with a foreign power (many of the lenders were foreign) would receive no defense from the federal government. The argument I present here is that outcome of the movement was a result of two factors: first, that debt burdens were unevenly spread across the states, with many states having little or no debt; and second, the coalition of heavily indebted states was insufficiently large to pass any bill favoring assumption. The following account suggests why some states were so much more indebted than others and how the power of those states was distributed in Congress.

Table 1 shows how great the variance was in indebtedness across the states in the early 1840s. Although some had assumed overwhelming debt burdens, others had none at all. Seven states had no debt, and an additional nine had per capita debt burdens of less than $10. Indeed, although the demands for public works may have varied somewhat across the states, there is reason to believe the explosion in spending throughout the 1830s which resulted in crushing debt burdens were inspired in part by political considerations. McGrane (1935) explains that "the southern states were overwhelmed with debts created by dishonest state officials" (p. 3), that "agents of the states violated statutes in negotiating [their] loans" (p. 8), and that "timid legislators shrank from the wrath of their infuriated constituencies as revelations of mismanagement and fraud in the use of public funds were disclosed" (p. 2). Similarly, Ratchford (1966) notes that the northeastern states were "inherently conservative" and that states such as "North Carolina and Georgia were kept out of the procession [of debt assumption] by bitter political divisions between the eastern and western parts of the states" (p. 87). That there was some corruption in some states does not negate the fact that large sums were spent on the

22. States with no debt would be credited with the federal treasury.

Table 1
American State Debts, 1841

	State Debt (thousands)	State Debt per Capita
Alabama	15,400	23.2
Arkansas	2,676	18.8
Connecticut	0	0
Delaware	0	0
Georgia	1,310	1.7
Illinois	13,527	21.6
Indiana	12,751	15.8
Kentucky	3,086	10.6
Louisiana	23,985	57.3
Maine	1,735	3.3
Maryland	15,215	17.7
Massachusetts	5,424	6.5
Michigan	5,611	19.6
Mississippi	7,000	15.0
Missouri	842	1.7
New Hampshire	0	0
New Jersey	0	0
New York	21,797	8.1
North Carolina	0	0
Ohio	10,924	6.4
Pennsylvania	33,301	17.0
Rhode Island	0	0
South Carolina	3,691	5.9
Tennessee	3,398	
Vermont	0	0
Virginia	4,037	3.1
Wisconsin	200	0.5

Source: H. R. Rep. No. 26 (1843).

economic infrastructure that fueled the U.S.'s economic development (North, 1961; Wallis, 1999, 2002, p. 34). Nevertheless, whereas all the states had access to debt, their use thereof varied wildly. We are left with a simple question: Why?

Consistent with the competitiveness hypothesis outlined above, I expect that the extensive use of credit was in large part a function of the competitiveness of state politics. To test this hypothesis on the early United States, Table 2 presents the regression results for a simple model of state debt and a number of alternative specifications. The dependent variable is per capita debt in 1841, the year in which states began to default and the move for federal

assumption gathered momentum.[23] The key independent variable is an indicator of electoral competitiveness, which is calculated as 1 minus a Herfindahl political concentration index.[24] Because the debts are a reflection of overspending over the previous two decades, the index is calculated on the basis of the proportion of time each party spent in the governor's office between 1820 and 1841.[25] Competition increases as the index ranges from 0 to 1. The model includes two other independent variables. The first is a control for state infrastructure needs, which is measured as the land area of the state divided by the number of years the state had been in the union. The intuition is quite straightforward—larger states have greater infrastructure needs, but those needs will decline with the number of years that state governments have had to invest in roads, canals, etc. To test the robustness of the findings, the table reports the results of additional models with alternative measures for infrastructure needs. The second control is a variable measuring the strength of third parties. Although related to competition, this measure more directly assesses the number of parties in a given state's party system. Roubini and Sachs (1989), Alesina and Perotti (1995), and others have shown that as the number of parties increases, fiscal outcomes decline. Finally, the model also includes dummy variables for Louisiana and Missouri, which are outliers. Various indicators of the partisan colors of state governments and a dummy variable for southern states have no effect on debt assumption, though the removal of the outlier dummies does slightly weaken the results. The results for several models are reported in Table 2.

Of course, one must be cautious in interpreting the results of a regression analysis with such limited degrees of freedom. Nevertheless, the theoretically interesting variables are significant in four of the five models. Prominent third parties exacerbate collective action problems vis-à-vis fiscal policy, whereas states with greater infrastructure needs assumed more debt. Most important, the results in the table support the competition hypothesis in all but one model. To provide a conservative estimate of the effect of competition I focus on Model 1, which has the lowest coefficient among the models in which it achieves significance. Moving from a hypothetical state with no

23. A time-series of state indebtedness is not available. The next year for which data are available is 1852.

24. Formally stated, the index is calculated as $1 - \Sigma \mapsto_i^2$, where $\mapsto_i$ is the ratio of time in office for party i between 1820 and 1841. I use the governorship as data for state Houses not widely available until 1835. Data collected from Glashan (1979).

25. Ratchford (1966) notes that 1820 "marked the beginning of state debts as we know them today" (p. 72). Note that for territories such as Arkansas and Michigan that became states after 1820, the electoral data begin with statehood.

Table 2
Determinants of State Indebtedness

Independent Variable	Model 1		Model 2		Model 3		Model 4		Model 5	
Competitiveness	–14.881**	(7.566)	–15.687*	(8.265)	–8.709	(8.203)	–18.491*	(9.181)	–20.179**	(8.386)
Third party strength	0.601**	(0.251)	0.363*	(0.198)	0.330*	(0.181)	0.428*	(0.218)	0.461**	(0.202)
Infrastructure needs	0.002***	(0.001)								
Land area (logged)			2.820**	(1.246)						
Years in union					–0.269***	(0.085)				
Population density							–0.040	(0.050)		
Gross domestic product per capita									–0.085	(0.052)
R^2	.71		.73		.77		.67		.70	

Note: $N = 26$. The dependent variable is per capita indebtedness in 1841. Results are coefficients with standard errors in parentheses.
*p = significant at .10. **p = significant at .05. ***p = significant at .01.

electoral competition at all to one with maximum competition decreases indebtedness by nearly $15 per capita. Given that the mean level of indebtedness in 1841 was only slightly above $11 per capita, the effect is quite large. Of course, none of the U.S. states had perfectly competitive electoral environments. Even still, moving from the least competitive state (Alabama, South Carolina, and Arkansas all score 0 on the competition index) to the most competitive (Vermont, which scores a .64) yields a decrease in the predicted value of per capita indebtedness by $9.52. Even a one standard deviation increase in electoral competitiveness (.18) yields a notable $2.68 decrease in per capita state debt, or about one third of the average debt burden.

With such variance in levels of indebtedness, the central issue became the influence of the pro- and antiassumption states at the national level. Given the national strength of the low-debt coalition, it becomes clearer why the federal government did not assume state debts in the 1840s. Despite the belief on the part of proponents in Congress that there were so many indebted states as to ensure the adoption of a plan (McGrane, 1935, p. 38), the data suggest otherwise. Simply put, enough states had avoided overwhelming indebtedness and wanted nothing to do with subsidizing the debts of the overspending states. Although the bill for assumption never made it to the floor, and we therefore do not have congressional debate or a vote on the bill to confirm the coalitions for and against a bailout, the historical record is quite suggestive. In a response to the move for federal assumption, Senator Benton of Missouri introduced a motion indicating that "such assumption would be unjust, unwise, impolitic, and dangerous, *compelling the non-indebted States to incur burdens for others which they have refused to incur for themselves* [italics added]" (S. Rep. No. 18, 1839). A later report by the Senate Select Committee went on to echo these sentiments:

> To throw the burden from one sovereignty upon another will not pay the debt, nor detract from its oppressiveness upon the people, *except so far as it may produce the unjust result of compelling one part of the people to pay the debts of another. . . . The states did not come into the Union with the expectation to be taxed for the payment of the debts of their sister States* [italics added]. (S. Rep. No. 153 at 15, 1840)

Clearly, the nonindebted states were sensitive to who would benefit most from a federal bailout. Indeed, the fact that the proposal would have made considerable payments to all states reflects the political calculations of the high debtors who recognized the need to purchase the acquiescence of low debtors for the bill to pass. But the low debt states were quite aware of the

future implications of assumption. The committee report cited above stated that assumption would be "establishing a dangerous precedent which must soon be followed up by new debts on the part of the States" (S. Rep. No. 153 at 1, 1840). And as Table 3 shows, those nonindebted or modestly indebted states far outnumbered the heavily indebted ones in Congress. Indeed, when we add together the representation in Congress of the states with modest or no debts, we can see that any move for bailouts was almost sure to fail. The fiscally austere states held 82% of the House seats and 62% of the Senate seats.

It is worth emphasizing that this outcome was not the result of a strong central government or the formal fiscal rules currently in vogue. Budget constraints were not as hard as they are today, and the federal government was immobilized by divisive debates over the expansion of the union. Essentially, this was a case where the politically competitive and fiscally prudent states served as a check on the uncompetitive and fiscally profligate ones. Equally important, it was the way in which the crisis was resolved which provided the foundations for the fiscal rules that contemporary research is so focused on. As Grinath et al. (1997) make clear, "Ultimately the debt crisis forced a change in the structure of state public finance. Beginning with New York in 1846, states began systematically to limit, by constitutional provisions, the issue of state and local debt" (p. 34). By 1960, 12 other states reformed their Constitutions with an eye toward institutionalizing checks on the government's capacity to accumulate debt.[26] Likewise, debt markets quickly internalized the fact that the states would sink or swim on their own. Larson (2001) explains that only after the crisis "did the private capital market, nursed into being by a generation's experiments in public investment, step forward and claim a theoretical and practical superiority over public enterprise" (p. 6). And as English (1996) shows, those states that defaulted had a harder time regaining access to capital markets and, generally speaking, did so at higher interest rates than those states that had not defaulted. Indeed, most of the defaulting states subsequently repaid their debts in large part to regain access to capital markets. It is difficult to imagine that any such movement toward market-preserving federalism would have taken place had the federal government assumed state debts in the 1840s. Rather than promoting the development of fiscal restraint, the assumption would have created incentives to overspend, borrow, and lobby for bailouts from the center.

Above and beyond the U.S. case, there is growing indirect evidence that regional politics are a central ingredient in shaping the quality of local

26. See Price (2002) for a detailed discussion of the role of the state debt crises in fostering formal fiscal rules in the case of Wisconsin.

Table 3
National Representation of Modestly and Heavily Indebted States

State	House of Representatives	Senate
Modestly indebted		
Connecticut	4	2
Delaware	1	2
Georgia	8	2
Maine	7	2
Massachusetts	10	2
Missouri	5	2
New Hampshire	4	2
New Jersey	5	2
New York	34	2
North Carolina	9	2
Ohio	21	2
Rhode Island	2	2
South Carolina	7	2
Tennessee	11	2
Vermont	4	2
Virginia	15	2
Total	147	32
Heavily indebted		
Alabama	7	2
Arkansas	1	2
Illinois	7	2
Indiana	10	2
Kentucky	10	2
Louisiana	4	2
Maryland	6	2
Michigan	3	2
Mississippi	4	2
Pennsylvania	24	2
Total	76	20

Note: Heavily indebted states are defined as those with per capita debts exceeding $10.

democracies and intergovernmental conflicts over economic policy. In Mexico, Díaz-Cayeros and Martínez-Uriarte (1997) find that local governments with higher levels of political competition invest greater amounts in the provision of public works. More broadly, Beer (2001) provides evidence that greater electoral competition fosters more professional and productive state legislatures who are better able to check the spending authority of governors. Not surprisingly, the states in the north, where electoral competition is centered, have been relatively less clientelistic, raised more of their own revenue, and played a central role in Mexico's democratization (Rodríguez,

1997). Likewise, in India, Khemani (2001) shows that opposition governments at the state level are less likely to accumulate significant deficits. Emphasizing the importance of state-level politics over intergovernmental finance, she argues that "sub-national deficits may be determined by the nature of electoral competition between political parties, and as long as decentralization does not change the nature of party competition in the federation, it may have no effect on overall consolidated government deficit" (p. 18). Findings in research on the Argentine provinces confirm Khemani's hunch. Remmer and Wibbels (2000) show that competitive provinces spend less on clientelism and run smaller deficits than uncompetitive ones. Similarly, Gibson and Calvo (2000) and Sawers (1996) show that clientelistic provinces have been remarkably successful at extracting resources from the central government.

What distinguishes these federations from the United States in the 1840s, however, is that none of them has the critical mass of competitive regions necessary to prevent many other states from pillaging the central government. Despite islands of competition, there is plenty of evidence as to the predatory nature of uncompetitive regions and the complications such governments introduce into intergovernmental relations. In Russia, "regional oligarchs" with strangleholds on electoral politics are a central obstacle to market reforms and democratization (Solnick, 2000). In Mexico, Harvey (1998) has underscored the traditionally clientelistic and repressive nature of politics in that nation's southern states. Likewise, with a few exceptions aside, clientelistic networks continue to dominate most Argentine provinces (Sawers, 1996), where some provinces have yet to see party alternation since the onset of democracy in 1983. Thus, contrary to most current analyses in the comparative federalism literature, the ongoing economic conflicts in many of these federations are not so much a result of poor formal budget rules, specifically, or even the balance between the central and regional governments, more generally, as the relative balance between democratic regions and their counterparts in authoritarian enclaves.

CONCLUSION

This article has two main theoretical lessons and one significant policy implication. First and at the broadest level, increased attention should attend regional politics in the study of federations. Most research is most directly concerned with the evolution of central-provincial bargains, particularly as they bear on the birth and viability of federations. In doing so, the tendency is to bracket the tremendous variation across regions. As suggested here, the

renegotiation of existing federal bargains are as much a function of the evolution of the relationships among regions as they are between regions and centers. This proposition has important implications for the trend toward centralizing authority as a response to the market-distorting incentives in some federations. The irony is that whereas central governments in the developing world's federations may be more market-friendly than their subnational counterparts, centralizing authority is unlikely to lead to market-preserving federalism. As such, the chief lesson of this research is that market-preserving outcomes will result only when regions themselves are attuned to the demands of markets, not when market-friendly centers attempt to impose discipline on authoritarian enclaves. This is not to suggest that the market-based outcome rooted in competitive federalism is necessarily the only appropriate or desired outcome. Indeed, it may be that Germany's rule-driven cooperative federalism is a more appropriate model for many of the federations in the developing world. It is to suggest, however, that proponents of market-preserving federalism need to pay closer attention to the subnational politics such models have generally underplayed.

Second, this article suggests that a strict focus on the formal budget rules can obfuscate as much as it explicates. With respect to the U.S. case, for instance, an analytical reliance on budget rules would provide insight into neither the variance of debts assumed across the states nor why the crisis was resolved as it was. One contribution of this article is in correcting a shortcoming of the market-preserving literature vis-à-vis soft budget constraints, namely that it provides a theoretical explanation for neither variance in the demand for bailouts across regions nor how federations move from market-distorting to market-preserving outcomes. The root of these institutions is likely in the contentiousness of regional politics and the national balance between pro- and antibailout regions. That being the case, the mechanisms whereby states are represented at the national level become very important. Had the method of representation more clearly favored the highly indebted states, the outcome likely would have been quite different. In exactly this sense, the work by Stepan (1999) and Samuels and Snyder (2001) on the overrepresentation common to many federations becomes quite pertinent to the economic conflicts of concern here. Nevertheless, the nature of intergovernmental and regional fiscal rules is almost certainly a function of regional politics, not the other way around.

With respect to public policy, the clear implication is that reformers should spend more time thinking about the electoral and political factors that underpin the emergence and sustainability of hard budget constraints than formal budget rules themselves. Partisan rivalry fosters incentives for fiscal transparency, strong budgetary institutions, and pecuniary oversight. The

temptation in the literature has been to view individual states within federations as part of a homogenous institutional environment that fosters either fiscal probity or overspending. The diversity of fiscal performance across states calls such analyses into question and helps focus attention on the subnational political foundations of federations. Writing on the United States in the 1840s, Grinath et al. (1997) suggest that although "it is tempting to view the individual states of the United States as part of a homogenous institutional environment" (p. 37), developments in the U.S. states were contingent on local factors. Then as now, the diversity of regional democratic circumstances deserve attention. And where those local circumstances are found lacking, resources would be better spent on fostering political contestation than reforming formal rules that are subject to evasion. Likewise, reformers should attempt to design institutions that make it harder for coalitions of profligate regions to be successful in national politics to ensure that hard budget constraints are binding on national governments. Of course, these are not terribly satisfying policy prescriptions for those interested in quick fixes, but they are likely to provide solid political foundations for the budgetary institutions which are the emphasis of most current research.

Finally, this research suggests one important new direction for future research. We know relatively little, comparatively speaking, about the conditions for subnational democracy and electoral competitiveness. That we know so little makes it hard to assess the degree to which the benefits associated with competition in the early United States are equally applicable in diverse contexts. In particular, we would like to know if competition functions differently in diverse electoral systems. It is plausible, for instance, that increased competition in multiparty contexts generates collective action problems consistent with the veto player literature. Thus, although the U.S. experience seems to be confirmed in the Argentine case (where most provinces have two-party systems), it is unclear if subnational electoral competition yields incentives for reform in the states of India or Brazil, where subnational party systems tend to be highly fragmented. Rather than fostering fiscal responsibility in the Brazilian context of multipartyism, might increased competition lead to higher numbers of veto players and a predisposition against transparency? Relatedly, does parliamentarism at the state level in India with its low representational threshold and irregular elections shorten political time horizons and negatively influence policy outcomes? The Mexican states represent an even greater puzzle, where the complex web of relationships between state governments, the national government, and the Institutional Revolutionary Party (PRI) raise difficult questions as to how to predict variations across cases in a context of incomplete democracy and a very recently demised one party state.

Perhaps most important, however, we know nothing about the microlevel conditions that traditional models of decentralization and federalism have assumed. Historically, the decentralization and federalism literatures have posited that highly informed local voters will be able to hold their local governments responsible either through the ballot box or by voting with their feet, that is, moving to other jurisdictions that more closely match their policy preferences. This assumption has underpinned the subsequent work on market-preserving federalism. Underlying this proposition are three individual-level assumptions: first, that local voters know which level of government is providing them with public goods and can hold that level of government accountable; second, that voters are mobile, or that voting with their feet truly is an option for citizens; and third, that local politicians are better able to judge the complex needs of local jurisdictions than national officials. To date, we have no research on any of these points outside of the U.S. case. Yet the plausability of these assumptions is crucial to understanding the links among decentralization, federalism, democracy, and economic policy. One tremendous benefit of the failed movement for federal assumption of state debts in the United States was that capital markets and voters could more easily assign responsibility for their states' fiscal and economic performance. If local citizens cannot identify which level of government provides them services or are not as mobile as has been assumed, their capacity to hold local and regional governments accountable is severely limited. Given the weight of current debates on the reform of federations, these issues are central to the functioning of these democracies and economies.

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Erik Wibbels is an assistant professor of political science at the University of Washington. His research focuses on market transitions, particularly in Latin America, and the political economy of federalism. His recent work has appeared in American Political Science Review, American Journal of Political Science, International Organization, World Politics, *and* Studies in Comparative International Development. *He is currently revising a book manuscript on the relationship between federal politics and market reforms in the developing world.*