

CHAPTER 31

FEDERALISM

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WIDELY regarded as the solution to the problems of enlarging governments, the attractions of federalism seem to never fade away. Discussions about the allocation of power across levels of government have been at the forefront of political analysis since the dawn of modernity. And they continue to be as European democracies struggle with the scope of the process of integration, whereas state-building processes are in progress in Iraq and Afghanistan. Meanwhile, an increasing share of the world's population lives under federal rule, making ever more truthful Riker's old assessment that we live in an *age of federalism*. Along the way, decentralization of political authority has managed to keep some pedigree as a way of promoting economic prosperity and democratic governance around the world. Yet, under this appearance of unwavering attention, the understanding of the origins and workings of federalism has been subject to profound transformations, ultimately reflecting shifts of similar magnitude in the scholarly approach to the subject.

The time when comparative works on federalism were seen as "few in number and spotty in quality" (Riker 1964, 157) is long gone. Back in those days, the field was primarily made of legal analyses of constitutional designs.¹ Based on the premiss that constitutions shape and steer the life of nations, this line of work was pretty blind to the realities of politics. Today's analyses are anchored on the opposite prior. Constitutions, much like business contracts, "do not spell out the rules and procedures to be followed in every conceivable instance in precise detail" (Dixit 1997, 20). As a

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¹ Examples of this type of approach to federalism include Wheare 1946; Bowie and Friedrich 1954; Livingston 1956; McWhinney 1962.

result, they are rewritten, manipulated by political actors who weight their preferences against the political realities of the time (Seabright 1996).

Between these two extremes, triggered by Riker's seminal contribution, the comparative politics of federalism has come a long way. The legal, and rather fragmented, analysis of constitutions has given in to a more comparative focus on different aspects of the functioning of federations. Politics has taken center stage. Similarly, the analysis of strategic interactions and their implications for the origins, evolution, and consequences of federations is clearly taking over more conventional and descriptive accounts. In the context of the economic turn in comparative politics (Levi 2000), the study of federalism has benefited from the *checks and balances* that economists and political scientists have imposed on one another. While economic models have brought to the field a much needed taste for theoretical and analytical rigor, comparativists of all kinds are adding intellectual value by shrinking the gap between theoretical premisses and the stubbornness of facts. Along the way, political economists have balanced normative concerns with a more positive approximation to federal realities, shifting attention from the optimal to the actual design of federations (Rodden forthcoming).

This chapter offers a necessarily partial review of the evolution, dominating themes, and pending tasks awaiting the comparative politics of federalism. The essay unfolds around one basic premiss, borrowed from rational choice institutionalism (Shepsle 1986). The study of institutions divides into (and combines) two levels of analysis: "In the first, analysts study the effects of institutions. In the second, analysts study why institutions take particular forms, why they are needed, why they survive" (Weingast 2002, 661). In line with this logic, the first section of the essay delimits federalism as an institution. The second section pays particular attention to the impact of federalism on democracy and the workings of the economy. Once the reasons why political actors should care about federalism have been outlined, the essay turns to the analysis of federalism as an endogenous institution, namely to the conditions under which federalism is more likely to emerge and survive. This section also brings up a number of methodological considerations on the comparative study of the origins and consequences of federalism. Finally, the essay concludes with a methodological note for caution and a discussion of the challenges that lie ahead of the field.

1. DELIMITING FEDERALISM

Federalism is a specific form of fragmentation of political power. The existence of several levels of government is a necessary, yet insufficient, condition for federalism to exist, as every state is articulated around some vertical hierarchy among different levels of government. What distinguishes federations from unitary states, unions, or

confederations is the particular way in which this hierarchy is organized. In unitary states, regional or provincial officials do not have constitutional status as effective actors in a bargaining process with the center. They lack control over power or resources, and therefore have no capacity to give or take in their interaction with the center. Collective choices in a unitary state are set by whatever version of the will of the majority of citizens is produced by the electoral system. In turn, unions are “polities compounded in such a way that the constituent units preserve their respective integrities, primarily or exclusively, through the common organs of the general government, rather than through dual government structures” (Watts 1999, 11). New Zealand or pre-1993 Belgium would constitute examples of this.

As opposed to unions or unitary states, federations and confederations show an architecture of government with dual structures, driven by a process of bargaining between a number of constituent units and a center.² The two of them face a similar dilemma, namely how to address the combination of *self-rule* and *shared-rule* (Elazar 1987). Yet, they offer clearly distinctive solutions. Confederations emerge when constituent units join efforts to create a common government that has very limited and well-defined powers and is fiscally and electorally dependent on them. Fiscal dependence implies that the common government lacks its own fiscal base, whereas electoral dependence refers to the fact that the members of the central government are delegates of the constituent units. The United States during the period 1776–89 or the evolving European Union are two relevant examples. In contrast, the balance of power between the center and the units is substantially different in federations. In a federal system, both constituent units and the central government have constitutionally recognized autonomous powers to interact directly with citizens (Dahl 1983; Watts 1999). Riker defined federalism as “a political organization in which the activities of government are divided between regional governments and a central government in such a way that each kind of government has some activities on which it makes final decisions” (Riker 1975, 101). The autonomy of these two levels of government is effectively guaranteed, normally through a formal statement in the constitution and the existence of a strong judicial review system. In addition, both the center and the regions have their own fiscal bases and are directly accountable through elections. As a result, central governments in federations (as opposed to confederations) enjoy a much stronger institutional position vis-à-vis subnational governments.

While a cursory overview of existing federations reveals that national governments have more power than subnational ones, the latter are far from powerless. Thus, the question still remains as to how to strike a balance between them, i.e., how to organize *shared rule* in the presence of two strong, directly elected, levels of government. Beneath this question lies the fundamental dilemma of federalism: how to devise a set of institutions that reconcile the ability of centralized government to create economies of scale and overcome the collective action problem in certain

² It goes without saying that these negotiations (and their outcomes) require a set of guarantees that are only effective in the context of democratic regimes (Dahl 1983).

realms, and the capacity to deal with the specifics of local issues (and the informational asymmetries associated with them) in others? Granting too much power to subnational units might jeopardize the former, whereas having too strong a central government might jeopardize the latter. This tension was already visible in the *Federalist* and the *Anti-Federalist* papers. After describing the calamities emerging from the ill-designed constitution of United Netherlands, in which “in all important cases not only the provinces, but the cities must be unanimous” (Federalist XX, 105), Madison and Hamilton move on to argue that strong state governments, holding veto powers across policy fields, bring about “contemptible compromises of the public good” (Federalist XXII: 118).³ Thus, in their view, there was little doubt that any activity involving externalities across states (such as revenue collection, defense, commerce regulations) was better handled by a properly empowered union government. In turn, the *Anti-Federalist* expressed the opposite fear, namely that too strong a center was likely to usurp the power of the states, thereby eliminating the advantages of allowing “decision based on local knowledge” (Ketcham 1986).

In solving this tension, federations vary a great deal, both in terms of the set of institutions and procedures that rule the interaction between levels of government and the nature of the specific agreements between the center and the units, as reflected by the levels of decentralization in different policy fields. The former are set constitutionally and tend to be more stable and consequential than assumed by approaches exclusively based on actors’ preferences. The latter are better understood as *congealed tastes* (Riker 1980), and are more amenable to change over time. Table 31.1 and Figures 31.1 and 31.2 illustrate this variation. In terms of the institutions mediating the interaction between levels of government, I focus on second chambers and different aspects of the party system. In terms of decentralization across policy fields, I include a number of indicators of fiscal decentralization.

An important source of variation among federations is the way in which regional interests are represented at the national level. While some countries rely upon territorial upper chambers (USA), others make use of regularly timed conferences between the executives (Canada) or even more informal, less structured agreements (Watts 1999; Swenden 2004). As reflected in Table 31.1, some second chambers are directly elected (Brazil, USA), providing a more direct representation of local constituencies, while others are indirectly appointed by regional incumbents (Germany, Austria), thereby facilitating a stronger influence of national political parties. Moreover, some upper chambers have strong powers to reshape the democratic majority (USA, Brazil), others enjoy much more limited political capabilities (India, Spain). Federations also differ in the extent to which national leaders are able to control the tendency of regional incumbents to maximize the promotion of local interests. Riker (1964, 1975) distinguished between centralized (or maximum) and peripheralized (or minimum) federalisms depending on the role attributed to the rulers of the federation. Figure 31.1 displays a simplified version of Riker’s index of party centralization that illustrates the differences

³ For an illustration of the benefits associated with centralized policy, see Hamilton’s defense of concentrating the taxation of imports at the union level (Federalist XII, 64).

Table 31.1 Federal diversities: an overview

	Expenditure decentralization 1998–2000	Revenue decentralization 1998–2000	Vertical imbalance 1998–2000	Borrowing autonomy by subnational governments	Upper House
Argentina	42.26	39.86	–	4	Indirectly elected by local chambers until 2001. Thereafter, directly elected
Australia	44.40	33.21	37.7	2.5	Directly elected
Austria	31.10	24.36	34.9	1.6	Indirect election: elected by state legislatures: weighted representation
Belgium	11.03	5.79	53.6		Mixed representation: combination of directly elected, indirectly elected by linguistic councils and co-opted senators
Brazil	42.8	33.7	35.1	4.5	Direct election
Canada	58.73	52.28	20.07	2.7	Appointed: by federal government, equal representation or provinces
Germany	37.54	30.9	22.31	2.5	Indirectly elected
India	45.22	33.0	36.11	2.5	Indirect election: elected by state legislatures: weighted representation
Mexico	29.4	22.8	35.4	2.6	Direct election at the state (3 per state) level with a limited number (32) of seats selected through national proportional representation
Nigeria	29.1	20.4	–	1	Direct election
Spain	32.40	19.3	54.15	2.5	Mixed representation. About 80% elected; 20% appointed. Note, however, that senators are elected along party lines
Switzerland	46.90	43.2	24.06	3	Direct election
USA	48.61	41.6	30.99	3	Direct election

Sources: World Bank-IMF Fiscal Decentralization Database (<http://www1.worldbank.org/publicsector/decentralization/fiscalindicators.htm>); Rodden 2004; Watts 1999; Arzaghi and Henderson 2005.

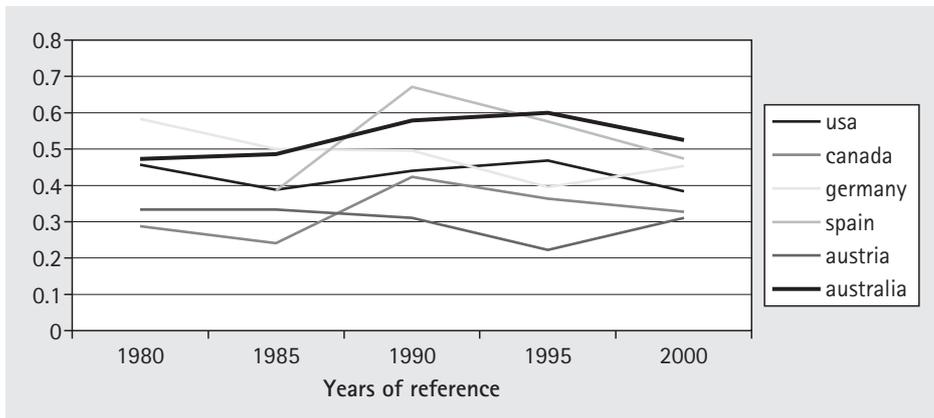


Fig. 31.1 Party centralization in six advanced federations (period averages)
Source: Author's calculations on the basis of national sources data.

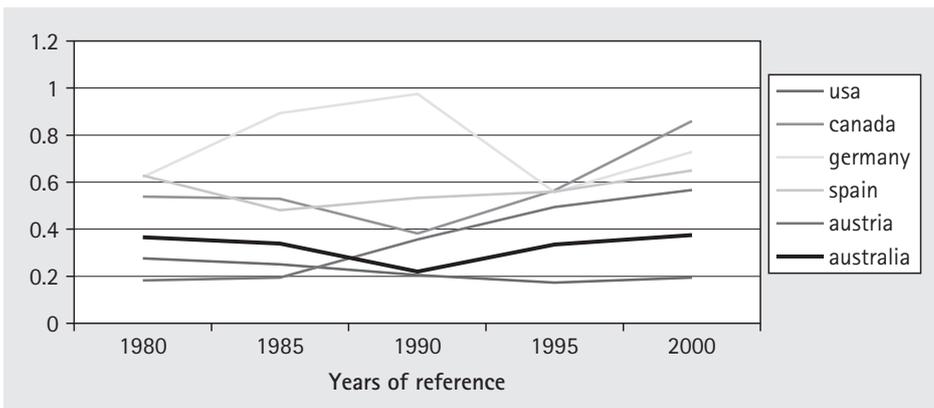


Fig. 31.2 Effective number of parties in six advanced federations: average regional deviations from national level (period averages)

in levels and trends in six advanced federations.⁴ More recently, scholars have abandoned this simple dichotomy, which tends to be far too focused on the particular experiences of the United States to recognize the multidimensional character of the articulation of federations (Stepan 1999). In particular, Riker's index does not tell much about how specific the patterns of political competition are in different parts of the federation. This speaks to the issue of electoral externalities. If the basic structure of political competition is similar across levels of government and electoral externalities are large, regional leaders

⁴ The index is defined as the share of regional governments controlled by the same party or coalition of parties that controls the federal government.

have incentives to trade some of their local interest for a share of the political rewards to be obtained at the national level. Alternatively, the more specific the nature of political competition at the regional level, the smaller the electoral externalities will be, and therefore, the more costly it becomes to compromise with the promotion of local interests.

The issue of how to measure the scope of these externalities is still unresolved. Figure 31.2 displays an admittedly imperfect measure, based on the assumption that the *effective number of parties* (ENP, as defined in Lijphart 1999) is a reliable indicator of the structure of political competition in any given electoral unit. Figures reflect the following calculation. For each region, I first calculate the absolute value of the difference between the ENP at the regional and the federal levels. Then, the value of the distance is averaged across the regions. If the value of the index is zero or close to zero, the structure of political competition is said to be similar across the different regions and the center. In turn, the higher the value of the index, the more diverse the electoral processes at different levels of government.⁵ Again, a good deal of cross-sectional and over-time variation is observable among federations.

Finally, a third dimension of variation concerns the distribution of authority across policy fields. Table 31.1 presents a few indicators on fiscal decentralization.⁶ The borrowing capacity of regions varies substantially across federations, as do the levels of expenditure and revenues decentralization. On the latter, it is important to note how similar levels of revenue decentralization mask different levels of fiscal subnational autonomy, captured indirectly by the varying degree of vertical fiscal imbalance in federations. Moreover, there is a good deal of over-time variation. For most of the twentieth century tax centralization was the dominant trend among federal democracies (Diaz-Cayeros 2004). Yet several of these federations have reversed the trend since the late 1970s, undertaking non-negligible processes of devolution of tax authority (Rodden 2004). To complicate matters further, fiscal centralization does not necessarily coincide with the centralization of policy authority, particularly in those fields in which the interaction between levels of government is done through regulatory policies (Falleti 2005; Hooghe and Marks 2003; Kelemen 2004; Rodden 2004; Schneider 2003).⁷ As a result, “there is no mechanical means of totting up the numbers and importance of areas of action in which either kind of government is independent of the other” (Riker 1975), in a

⁵ This indicator is open to obvious shortcomings. Suppose that two regions have a similar ENP, but only one of them has a strong nationalist party. Obviously, the nature of political competition is going to be very different in each of them. To overcome this and other limitations, Rodden and Wibbels 2005 have recently proposed to measure electoral externalities through the partial association between the support received by federal parties in national elections and the support these same parties obtain in regional elections.

⁶ Expenditure (revenue) decentralization are defined as the percentage of subnational government's expenditures (revenues) out of total government expenditures (revenues). In turn, the vertical imbalance represents the degree to which subnational governments rely on transfers from the central government to finance their expenditures. Finally, the scale for borrowing autonomy captures the scope of the limitations by central governments on subnational borrowing. It ranges between 1 and 5. For sources and details, see Rodden 2004.

⁷ For an innovative analysis of the distribution of regulatory powers in federations, see Kelemen 2003.

context in which clear-cut distributions of authority are the exception rather than the rule.

Regarding variations over time in terms of party centralization, party centralization and policy decentralization suggest that the observable equilibria between the center and the units are necessarily unstable (Bednar 2001). As Rufus Davis (1978) puts it, “at best the federal compact can only be a formalized transaction of a moment in the history of a particular community.” In sum, federalism constitutes a complex reality in constant flux, quite distant from the clean, binary world suggested by merely formal or constitutional typologies. As we shall see in the rest of this chapter, the history of the comparative politics of federalism is to a large extent the history of a rediscovery of these complexities as the key factor to a better understanding of the workings of federalism, as well as the conditions under which it constitutes a viable institutional choice. The next section develops this point in detail by focusing on the literature involving the political and economic consequences of federalism.

2. THE IMPACT OF FEDERALISM: COPING WITH DISILLUSION

Federalism does make a difference. It alters the set of options and constraints faced by political actors at two different levels of government, thereby modifying actors’ political preferences, as well as the overall structure of incentives (Rose-Ackerman 1981). The real issue is what kind of difference federalism makes. Interestingly, had we been confronted with this question two decades ago the task would have been rather simple. Under the lead of welfare economists or public choice theorists, the answer would have read as follows: federalism breeds better democracy, better bureaucracies, and better markets. In contrast, today’s answer would be far less cheerful. A cumulative body of empirical and theoretical research suggests that the old expectations constituted, at least partially, a *federal illusion*. Nowadays, it is clear that the political and economic effects of federalism are complex, multidimensional, often contingent on a number of other factors, and by no means always positive. As a result, it is far less straightforward to establish what the actual consequences of federalism are. Paradoxically, this reflects a good deal of progress in a field that has been able to part ways with highly stylized, mostly normative, models of federalism to engage into a positive reconsideration of how federations actually work. In turn, this new wave of positive analyses is providing the building blocks for a much longed for, and not yet achieved, articulation of a general theory of the origins and performance of federations.

The new comparative literature on federalism is voluminous. Political scientists and economists have joined forces to produce a very rich body of research that revolves around one major theme: when it comes to the political and economic consequences of

federalism, the evil is in the details. By details I refer to both the specifics of the institutional design and the surrounding economic and social circumstances. The remainder of this section brings to task the main elements of the federal illusion by reviewing the main contributions of the comparative politics of federalism. I will concentrate first on the relationship between federalism and democracy; thereafter I will address institutional stability and the notion that federalism improves the workings of bureaucracies and markets.

2.1. Federalism and Democracy

Classical theorists commend federalism for its ability to accommodate communities of different political taste and protect political liberties at the same time. Echoing Hamilton, Madison, and Jay, Tocqueville (1835/1964) celebrated federalism as a system “created with the intention of combining the different advantages which result from the magnitude and littleness of nations.” In *Democracy in America* he linked protection against foreign threats to the former and a government in which “all the efforts and resources of the citizens are turned to the internal well-being of the community” to the latter. In limiting the sovereignty of the Union, federalism would prevent large-scale governments from imposing the “tyranny of the majority” upon political liberty and good governance. Because of these two characteristics, federalism is often regarded as a facilitating condition for the establishment and duration of democracy in large, heterogeneous nations.

However, a systematic overview of the fate of large-scale, democratic federations provides a mixed picture, posing a more general, and still unresolved, set of puzzles: under what conditions does federalism facilitate democracy? Under what conditions does federalism help integrate ethnic, linguistic, or religious divides? Recent assessments range from moderate optimism to outright skepticism.⁸

Linz (1997) argues for a clear distinction between those cases in which state institutions and rule of law are consolidated before the transition to democracy begins and those in which they are not. In the former, the pre-existence of a federal structure fosters, rather than prevents, conflict, violence, and regime failure. In the latter, federalism would display its capacity to accommodate contending national identities. After coordinating a large comparison across federations, both advanced and developing, Amoretti and Bermeo (2004) lean to conclude that federalist arrangements facilitate successful accommodation. Yet, in the same volume, Bunce (2004) shows that, in the subset of post-communist regimes, democracies emerging in a pre-existing federal setting tend to be more vulnerable to the secessionist pressures of pre-existing groups. Several possible explanations have been offered to account for these differences. Bermeo (2004) suggests that federations that remain as a legacy of authoritarian regimes are less successful than federations emerging from a contractual agreement. In turn, Stepan (2001) points to the

⁸ For earlier, generally skeptical, treatments of these issues, see Duchacek 1970; Riker and Lemco 1987; Lemco 1991.

internal articulation of power within federations. The higher the institutional leverage given to already mobilized ethnic minorities, the lower the likelihood that federations are able to prevent territorial disintegration.⁹

While suggestive, these explanations are applicable to a small subset of cases. In one of the few quantitative studies in the field, Roeder (2000) takes the most optimistic views to task. On the basis of information for 132 countries and 632 ethnic groups for the period 1955 to 1994, Roeder comes to conclude that both symmetrical and asymmetrical forms of federalism “lead to significant increases in the likelihood of ethno-national crises.” Yet, further case study evidence continues to show that the specifics of how federations are designed account for their ability to contain conflict and prevent disintegration (Hale 2004; Filippov, Ordeshook, and Shvetsova 2004; Stepan 2001; Treisman 1999). Overall, the sharp contrast between different kinds of evidence suggests that the analysis of the relationship between federalism and democracy would benefit from reallocating research efforts to the theorization of the mechanisms of processes through which federalism produces different outcomes.

How does federalism shape the incentives and strategist of reformist leaders? In turn, how does democracy affect the interaction between regional and central incumbents? How do alternative federal designs respond when multiple cleavages are politically relevant? And finally, how do alternative federal designs feed back into the incentives of different subnational groups to politicize cultural, ethnic, religious, or income differences (Fearon and Van Houten 2002)?

Recent developments in Russia and Iraq are making these questions ever more pressing. A number of scholars are focusing on the relationship between income inequality, federalism, and democracy. Boix (2003) has recently argued that insofar as it decentralizes the control over redistribution, federalism facilitates the survival of democracies with high levels of inter-regional income inequality. In turn, Hug (2005) focuses on the implications of income disparities for federal stability. A second group of scholars have focused on issues of institutional design in transitioning societies. Taylor (2005) addresses the issue of stability in hybrid federal democracies, where the conventional stabilizing mechanisms (political parties, courts) are yet to be institutionalized. Taylor points to the control over coercive power as an overlooked dimension whose organization bears importance on federal stability. Myerson (2006) focuses on electoral sequences, arguing that holding local elections first facilitates the selection of better (i.e., more responsive, less corrupted) leaders at the national level, thereby helping create a better democracy. In contrast, Filippov and Shvetsova (2005) use the Russian experience to suggest the existence of a tradeoff between federalism and democracy: in societies in transition, an ill-functioning democracy is a prerequisite for territorial integration. Local elites will contribute to stability insofar as they can keep extracting rents. Thus, as soon as political competition becomes effective, territorial integration is in peril.

⁹ Within this framework the existence of a polity-wide (*demos enabling*) party system, able to hold the different units together throughout the transition and consolidation processes, is regarded as particularly important.

While these contributions shed light on some of the mechanisms driving the relationship between federalism and democracy, there is much to be learned about how different federal designs affect the preferences, incentives, and strategies of actors divided along multiple dimensions before any consensus is to emerge. This is particularly true in those societies in which both federalism and democracy are the object of institutional changes. Clearly, the big picture is yet to be painted.

2.2. Federalism and the Economy: towards a new consensus?

The implications of federalism for the adoption and stability of democratic regimes constitute just one aspect of the high hopes theorists put on federal institutions. As a matter of fact, the bulk of the federal illusion lies elsewhere. During the years of pluralist hegemony, the comparative study of political institutions was not at the top of the research agenda in comparative politics. Indeed, Riker himself declared that insofar as institutions were a mere reflection of the underlying preferences in society, there was little reason to expect meaningful effects of federalism on public policy. Public economists felt differently, and in their quest to establish the optimal design of the public sector proceeded to fill the gap.

Welfare economics and Public Choice theory, while anchored on opposite, yet equally ideological assumptions, came to reinvigorate the *federal illusion*. Welfare economists were concerned mostly with market failures and the problem of externalities. In sharp contrast, public choice theorists were concerned with public sector failures and how to control the predatory, rent-seeking, behavior of public officials. And yet, they came to similar conclusions about the economic benefits of federalism. For *welfare economists* (Musgrave 1997; Gramlich 1973, 1987; Oates 1972, 1991, 1999; Wildasin 1991), a decentralized institutional design works towards the goal of an optimum allocation of resources by ensuring a better fit between preferences, needs, and policies and by facilitating experimentation and innovation. Within this framework, factor mobility operates primarily as a factor of preference revelation for welfare-maximizing incumbents.¹⁰ In turn, for *public choice theorists* (Brennan and Buchanan 1980; Buchanan 1995, 19–27; Inman and Rubinfeld 1997a, 73–105; Qian and Weingast 1997, 83–92; Weingast 1993, 286–311; 1995, 1–31; Weingast, Montinola, and Qian 1995, 50–81), federalism is *market friendly* because it restrains the predatory nature of the public sector. Within this framework, factor mobility operates as a factor constraining government's predatory tendencies. By allowing voters and factors to vote with their feet across jurisdictions, federalism facilitates a better monitoring of incumbents by markets and voters.¹¹ As a result,

¹⁰ Provided that the demand for local public services is income elastic, that these services are financed by income taxes (Oates 1972, 1991) and that there is perfect mobility, Tiebout's model predicts that communities become homogeneous in income and heterogeneous in capacities. For a critical evaluation of the benefits and shortcomings of these assumptions, see Stiglitz 1983, 17–55; Rose-Ackerman 1983, 55–85; Bewley 1981, 713–40; Zodrow 1983; Panizza 1999, 97–139.

¹¹ The relationship between mobility and redistribution in federal systems is a field of its own. For a more detailed treatment on the subject, see Peterson and Rom 1990; Epple and Romer 1991; Glatzer and Konrad 1994; Oates and Schwab 1988; Lejour and Verbon 1996; Christiansen Hagen, and Sandmo 1994.

corruption is less likely to occur, the public sector is smaller (Prud'homme 1995), and markets work more efficiently. In sum, both streams of public economic theory provided the grounds for a revival of the *federal illusion* that thrives across academic departments, national governments, and international organizations.

Alas, reality did not follow suit (Rodden and Rose-Ackermann 1997). A systematic overview of the economic record of federations suggests a more complex set of empirical regularities. Federations in developing countries appear to be systematically associated with mismanagement, overspending, and market failures rather than with the virtuous properties spelled out by normative public economists (Wibbels 2000; Ziblatt and O'Dwyer forthcoming). At the other end of the spectrum, advanced federations, such as the USA or Switzerland, are vindicated as illustrations of the positive effects of federal institutions. Moreover, it is by no means clear that federalism per se leads to less redistribution (Pierson 1995; Beramendi 2003; Obinger, Leibfried, and Castles 2005).

The observable differences across federations in terms of economic performance and distribution reflect a large gap between the implicit assumptions about politics and institutions underpinning political-economic models and the actual behavior of regional and federal governments in federations (Rodden 2006; Srinivasan and Wallack forthcoming; Treisman forthcoming; Wibbels 2005a). To be sure, "it does require maturity to realize that models are to be used but not to be believed" (Theil 1971) and demanding a perfect match between any model's assumptions and each empirical experience under study quickly grows absurd. Yet, the usefulness of theoretical models in explaining the performance of federations hinges critically upon how restrictive a conception of politics comparativists are prepared to accept.¹²

The need to bridge this gap between theories and facts, between the *federal illusion* and a disappointing reality, has been the engine behind the scholarship on federalism over the last two decades. In the context of this general effort, political elites are assumed to maximize their chances to gain and retain office rather than the amount of rents they are able to extract. Moreover, scholars have come to recognize, more or less explicitly, that the best route to establish the consequences of federalism is not to focus exclusively on the underlying forces and preferences in the political system (in the old *Rikerian* way) nor to conceive of institutions as abstract entities able to reshape preferences and incentives in any given social context (in the old *institutional economics* sense), but rather in the interplay between the two of them. As a result, research efforts concentrate on two areas, namely the social and economic circumstances on which federalism operates and the political and economic implications of the specific articulation of power in federations under different contexts. The former illuminate the preferences and incentives of the major players in the federal bargain. They also speak to the effectiveness of some of the constraints highlighted by the literature, such as the actual levels of capital or labor mobility. The latter account for the interactions between federal and local governments, and how these interactions translate into policies conducive to different outcomes.

¹² For instance, conceiving of political leaders as *welfare maximizers* severely limits our ability to account for the varying degrees of economic performance in federations, as indicated by public choice theorists themselves.

2.2.1 *Social and Economic Conditions in Federations*

Governments' preferences and citizens' ability to hold them accountable are to a large extent a function of the societal and economic conditions surrounding them. Consider first the distribution of "social capital." If the principal (citizens) is poor, uneducated, or socialized in a polity where the rule of law has given way to private exchanges between patrons and clients, agents (i.e., political elites) likely hold office with the purpose of maximizing their clients' rents, as well as their own. In these contexts, civic virtues lag behind in society's pre-eminent values. As a result, the dynamics of local politics disrupts rather than facilitates the efficient working of the economy (Wibbels 2005a; Treisman forthcoming). In contrast, a better-educated principal, coupled with a generally endorsed set of principles guiding public life and a consolidated legal system, creates a very different interaction between principal and agents. Electorates are more likely to punish outright rent extractions by public officials and reward good governance and economic performance. Incumbents will seek to remain in office by maximizing the satisfaction of a majority of the members of their respective *demoi*.

A second structural condition concerns the degree of asset specificity across regional economies. Asset specificity conditions the effectiveness of the constraints typically associated with labor and capital mobility as the degree of factor mobility decreases with the degree of specialization of the regional economy (Boix 2003; Beramendi 2004). In a specialized, asset-specific economy, human capital and skills are tied to the regional labor market. In addition, capital is less responsive to tax advantages and more sensible to the fit between its production needs and the characteristics of the labor force and educational system (Lucas 1990). As a result, incumbents in the richly endowed units may be less constrained by the potential externalities of decisions adopted in other jurisdictions and more constrained by the likely formation of cross-class regional coalitions. Moreover, heterogeneity among units alters the incentives of the poorly endowed units. Since capital is likely to flow from poor to rich regions, they abandon any attempt to promote economic efficiency through policy. As a result, capital mobility facilitates rather than disciplines the ability of poor units' incumbents to engage in ineffective public policy (Cai and Treisman 2005a). This introduces a different dimension that cuts across the level of economic development and institutionalization of civic values.

Federalism operates in a variety of contexts including advanced, specialized economies; advanced, non-specialized economies; backward, specialized economies; or backward, non-specialized economies. Insofar as federalism and decentralization link public policy to subnational political economies, the nature of the latter will be in part reflected in the economic consequences of federalism. Advanced, virtuous political economies will lead to good economic outcomes, whereas local, unconstrained, nests of corruption will perform poorly. In other words, the economic impact of adopting a federal, highly decentralized system is to a large extent context specific.

There is, nonetheless, a good deal of internal variation among both advanced and developing federations that cannot be accounted for by making references to their social and economic structures. However critical it might be, context specificity covers only half the gap between the federal illusion and the empirics of federations.

The second half concerns the interplay between incumbents' incentives and the specific architecture of power in federations. This brings us to issues of institutional design and cooperation in federations.

By introducing competition between several policy suppliers, federalism sets the stage for central and subnational governments to behave non-cooperatively. Incumbents at both levels of government seek political credit for the goods and services provided to citizens while they aim to minimize the costs incurred in satisfying citizens' demands (Migué 1997; Volden 2004, 2005; Inman and Rubinfeld 1997a). They also seek to minimize the electoral impact of unpopular policy reforms. As a result, subnational governments often incur high levels of debt to be paid by the rest of the federation through a federal bailout. More generally, federations often confront a moral hazard problem: local authorities take advantage of federal risk-sharing schemes to enact policies that increase local risks (Persson and Tabellini 1996b). Symmetrically, by decentralizing social programs without transferring the necessary resources, central governments manage to offload to regional incumbents the political costs of retrenching publicly provided social welfare.

Examples of this non-cooperative behavior plague the daily life of federations, thereby bringing back to the fore the same dilemmas confronted by Hamilton, Madison, and Jay (De Figueiredo and Weingast 2005; Inman and Rubinfeld 1996): how to monitor and constrain the uncooperative behavior of subnational units without creating an overpowered, unconstrained central government? Symmetrically, how to restrain the center's power, thereby preventing it from overawing the states, without facilitating at the same time defection from the federal contract by subnational units? In pursuing a definite answer to these questions, scholars' attention has turned to two intertwined aspects of the design of federations, namely the financial self-reliance of subnational units and the different ways of institutionalizing *shared rule*.

2.2.2. *The architecture of power in federations I: the fiscal constitution*

Financial self-reliance of subnational units combines fiscal autonomy and fiscal accountability. Fiscal accountability refers to the extent to which subnational units actually internalize the consequences of their economic behavior. As such, it presupposes high levels of fiscal autonomy, i.e., that subnational governments rely more on their own revenues and less on transfers from the federal government. Yet, the reverse is not necessarily true. Fiscal autonomy does not always imply high levels of fiscal accountability. Subject to soft budget constraints, fiscally autonomous regions may incur large debts and transfer the costs of fiscally irresponsible policies to other units in the federation. Thus, for a subnational unit to be fiscally self-reliant, hard budget constraints must be in place. If the central government bails out subnational ones from their financial obligations, macroeconomic outcomes tend to worsen while subnational units become more transfer dependent.¹³ To this effect, regional transfer dependency is associated with a

¹³ In looking at a number of countries with soft budget constraints, Wibbels 2001 illustrates how decentralized federations are less likely to generate crises in a number of macroeconomic outcomes (budget, inflation, debt) as own source revenue generation increases. See also Bardhan and Mookherjee 2006.

higher demand for bailouts (Rodden 2002) and resistance to market reforms (Wibbels 2003). There is some evidence though that, in the event of bailout by the center, subnational units lose capacity to resist institutional changes towards the hardening of budget constraints (Rodden, Eskeland, and Litrack 2003).

However, assuming that sufficiently hard budget constraints are effective, a cumulative body of literature indicates that as the fiscal autonomy (transfer dependency) of subnational governments increases (decreases), markets function better and economic outcomes improve.¹⁴ The specialized literature sees in China an example of the benefits of fiscal autonomy, whereas, arguably, the lack of autonomy of Russian regions leads local elites to be corrupted by large national companies, thereby hampering national economic growth (Qian and Weingast 1997; Bardhan and Mookherjee 2005). Stein (1999) reports findings along the same lines: Latin American decentralization tends to produce larger governments, but this effect is particularly important in cases where vertical imbalance is high, transfers are discretionary, and the degree of borrowing autonomy by subnational governments is high. More generally, both the size of government and the macroeconomic effects of expenditures decentralization are shown to be contingent on the levels of fiscal autonomy (Rodden 2003; Rodden and Wibbels 2002; Careaga and Weingast 2000). Fiscally autonomous subnational units reduce aggregate deficits and inflation rates and facilitate sustained economic growth. A compelling economic logic underlies this evidence. As greater financial self-reliance affects the extent to which subnational governments internalize the benefits of their economic progress, subnational incumbents have a strong incentive to create a market-preserving environment.

In sum, fiscal autonomy operates as a first barrier against the uncooperative behavior of subnational governments. In contrast, convoluted intergovernmental fiscal arrangements provide a natural breeding ground for political and economic opportunism. Yet, its importance notwithstanding, the economic effects of federalism and decentralization are not derived exclusively from the design of the fiscal constitution. In fact, as reflected by the recent path-breaking contributions by Wibbels (2005) and Rodden (2006), the ultimate key to the strategic interactions between different levels of government lies elsewhere, namely in the specifics of the articulation of shared rule across federations.

2.2.3. *The architecture of power II: the organization of shared rule*

In particular, three dimensions of the distribution of power in federations are regularly mentioned as the source differences in the economic performance of federations. These are the relative strength of the national executive, the formal representation of subnational units within the national policy-making process, and the organization of party systems.

¹⁴ The effectiveness of hard budget constraints is not straightforward. Legal provisions not to bail out subnational governments may not be enacted, giving way to an strategic interaction between the center and the units where the identification of bailout expectations becomes crucial. On the difficulty of empirically identifying bailout expectations and their implications for fiscal outcomes in federations see Rodden 2005.

Economists repeatedly contend that strong executives elected by national constituencies are in order if efficient national policy is to prevail over vested local interests (Inman and Rubinfeld 1996; Breton 1996; Eichengreen and Von Hagen 1996; Wildasin 1997; Persson and Tabellini 1996b). Yet, an excessive empowerment of the central executive provides no magic solution. For one, it defeats the very purpose of federalism in that it effectively eliminates the self-rule by constituent units. Second, an unrestrained national executive has plenty of incentives to overrule regional and local governments and extract a larger share of rents (De Figueirido and Weingast 2005). In addition, strong central governments become themselves targets for rent-seeking practices, including bailout claims (Wibbels 2005a; Rodden 2006). Thus, the issue still remains how to preserve the autonomy of local elites while limiting their incentives to distort the market at the same time.

A rich theoretical literature has focused on the importance of formal decision-making rules and procedures (Inman and Rubinfeld 1997b; Cremer and Palfrey 1999, 2000).¹⁵ The logic is simple and compelling: different designs create different sets of winners and losers depending upon the composition of preferences within each unit and the federation as a whole (Dixit and Londregan 1998). Hence, under any particular design, actors will make use of their strategic advantage to maximize the rents they are able to extract. These models complement a growing body of empirical evidence on how the organization of political representation, in particular, upper chambers as the institutional mechanism linking subnational specific interests to national policy making, condition the economic outcomes of federations. The recent work by Wibbels (2005a) on the determinants of market reforms in developing federations has placed the system of representation of regional interests at the center of the analysis. Given that policies are made at the national level, the fate of market reforms is in part explained by the ability of regions to use their formal representation in national institutions to obstruct or shape reforms. Wherever upper chambers play an important role in defining market reforms, the nature and scope of reform reflects the bargaining power of the regional coalitions for and against specific policy changes.¹⁶

However, the leverage granted to subnational units by the system of representation may be offset by a different mechanism mediating the interplay between national and subnational elites, namely the organization of the party system. Wibbels (2005a) analyzes the degree of partisan harmony as a mechanism that facilitates the coordination among regional and national incumbents, thereby facilitating the conditions for a

¹⁵ This literature complements a second set of theoretical models that focus on the differences between federal and unitary polities. For instance, Persson and Tabellini 1996a have pointed out that the balance between risk sharing and redistribution depends upon the formal rules of decision making: while centralization leads to overinsurance and larger levels of redistribution, bargains among constituent units produce underinsurance and a smaller fiscal system.

¹⁶ Reasoning along similar lines, Diaz-Cayeros et al. 2003 contend that unicameralism and parliamentarism reduce capital spending since they limit the number of independently elected politicians that must assuage their constituents through particularistic projects. In turn, Gibson, Calvo, and Falleti 2004 show that if poor, underpopulated units are overrepresented in the upper chambers, federalism severely constrains macroeconomic efficiency. Finally, Wibbels 2003 shows that strong and malapportioned senates increase the probability that a pro-bailout coalition emerges.

more successful policy change. But it is Rodden's (2006) analysis of fiscal discipline in federations that analyzes more in detail the mechanisms through which the design of the party system shapes the interplay between national and subnational elites.

Under unclear divisions of authority, governments at different levels have incentives to transfer the fiscal burden of their policies to other levels. In particular, subnational governments have an incentive to incur debt and hope to be bailed out by the center whenever the financial crisis reaches its limit. Because regional governments do not know how committed to fiscal discipline the central government is, they will adjust their fiscal behavior according to their expectations regarding the central government's resoluteness. Integrated national party systems, Rodden argues, make the resoluteness of the central government more credible and facilitate the enforcement of fiscal discipline by reducing the incentives for regional incumbents to behave irresponsibly.

An integrated party system affects the incentives of subnational incumbents in two different ways. First, local elites regarded as a liability for the overall electoral profile of the party face severe consequences in terms of their own political careers. As a result, the opportunistic behavior by local incumbents is likely to be constrained and, other things being equal, economic results improve (Wibbels 2001; Rodden and Wibbels 2002; Enikolopov and Zhuravskaya 2003). Second, an integrated national party system helps solve the commitment problem between incumbents at different levels of government by intertwining their political fates. In turn, partisan harmony and electoral coattails feed back on each other, facilitating the long-term cooperation between different levels of government and the party's organization. In turn, this makes the commitments between local and national elites more credible, and facilitates the renegotiation and ultimate improvement of ill-designed fiscal federal arrangements.

Overall, the effects of federalism on the economy are anything but simple.¹⁷ Similarly, the notion that federalism restrains the development of an economically inefficient welfare state is dubious as subnational units often engage in politically profitable social spending in the hope that the actual cost is transferred to other units through a variety of centralized fiscal arrangements. Empirically, federations vary largely in terms of both the size of the welfare state and the overall levels of inequality.

In sum, depending upon external conditions and internal features, federalism may or may not discipline fiscal policy, constrain redistribution (Beramendi 2003; Obinger, Leibfried, and Castles 2005), promote corruption (Cai and Treisman 2004; Bardhan and Mookherjee 2005), or facilitate the development of a market economy. While the field has advanced significantly in mapping out different combinations between underlying conditions and observed institutional effects, some of the nuts and bolts behind these combinations are yet to be ascertained (e.g., the workings and interdependencies of the many electoral externalities existing in federations).

¹⁷ The tension between competing political elites responding to different sets of incentives speaks to many other aspects of the federal illusion, such as the problem of policy experimentation. The literature on federalism and innovation is a field on its own. For reviews and critiques of the classical arguments on federalism as a laboratory for policy innovation, see Rose-Ackerman 1980; Strumpf 2002; Cai and Treisman 2005b. For a recent vindication of the link between federalism and policy innovation, see Kotsogiannis and Schwager 2004. To my knowledge, a systematic empirical analysis addressing whether federalism actually leads to more and better policy innovation is still lacking.

More importantly, the new picture of federalism painted by comparative political economists begs the question of how federalism and decentralization came into existence in the first place. This is especially relevant because whatever effect federalism and decentralization trigger (given the surrounding social, political, and economic environment), it is likely to be a long-term one due to the status quo bias of federal institutions.¹⁸ Hence, whenever the choice to adopt a federal constitution is made or steps towards political decentralization are taken, political actors are making a decision whose implications are meant to last.

3. REVISITING THE ORIGINS OF FEDERATIONS

Largely spurred by the new style and findings of the literature on the consequences of federalism, the analysis of the origins of federalism is on its way to producing a new understanding of the processes that account for the emergence and stability of federations. From the traditional insistence on a semi-open list of “conditions” for federalism, the field has moved to take on issues of endogeneity and selection, opening an entirely new set of questions. After a succinct overview on the traditional approaches to the origins of federations, I shall focus more extensively on the challenges faced by this newer stream of scholarship.

3.1. Pre-Rikerian Efforts: conditions for federalism

Until the appearance of Riker’s (1964) *Federalism*, the literature on the origins of federations was traditionally dominated by apolitical approaches. The features and circumstances surrounding past and present federations resulted in items on a list of “conditions” to be satisfied if a federation was to emerge. This line of work was very inductive in its logic. Thus, federalism would emerge as the institutional correlate of a number of cultural, historical, or even ideational characteristics of societies. The proposed lists of conditions vary in scope and detail. Deutsch (1957) centered his analysis on the level of “societal interaction” and “communication,” between both territories and social groups. When structural circumstances facilitate the development

¹⁸ After a challenging formal deconstruction of all the arguments conventionally used to either promote or warn against political decentralization, Treisman forthcoming indicates that “one argument did seem to be more generally valid. If political decentralization increases the number of actors whose acquiescence is needed to change policies, this will tend to entrench the status quo,” provided that preferences are sufficiently heterogeneous. For instance, veto power analyses show that federalism was instrumental in preventing change in fields as diverse as the expansion or retrenchment of the welfare state (Obinger, Leibfried, and Castles 2005), central bank independence (Treisman 2000), or fiscal federal arrangements.

of these links, federalism as a “security community” emerges. In turn, Wheare (1946), and Bowie and Friedrich (1954) broaden the list to include conditions such as the existence of a common institutional history, the existence of a source of military insecurity, a committed leadership, or a “community of outlook based on race, religion, language or culture” (cf. Riker 1975, 115).

Riker’s work departed from earlier contributions in two ways. First, his list of conditions was strictly political. These were: (1) “a desire on the part of politicians who offer to bargain to expand their territorial control by peaceful means, usually either to meet an external military or diplomatic threat or to prepare for military or diplomatic aggrandizement;” and (2) “a willingness on the part of politicians who accept the bargain to give up independence for the sake of the union either because they desire protection from an external threat or because they desire to participate in the potential aggression of the federation” (1975, 114). But, second and more importantly, Riker’s conditions follow from the theoretical breakthrough that the “establishment of a federal government must be a rational bargain among politicians” (Riker 1975, 116).

Herein lies the fundamental contribution by Riker to the study of the origin and functioning of federations. While it is widely acknowledged that Riker’s specific predictions regarding the centrality of “a military or diplomatic threat” do not bear empirical scrutiny (Stepan 1999; Ziblatt 2006), it is equally true that by focusing on politicians’ incentives, Riker deployed the foundations of all subsequent analyses of the origins and stability of federations in two important respects (Filippov 2005). First, Riker is the first to conceive politicians as strategic actors whose preferences derive from a balance between the status quo and their expectations about future institutional alternatives. Second, these institutional alternatives matter because they have distributive effects, that is to say they “produce different distributions of relative winners and losers” (Filippov 2005, 99). As a result, by conceiving the federal bargain as a choice between alternative distributive scenarios, Riker’s theory rooted the terrain for a new perspective on the origins of federations and political unions.¹⁹

3.2. Looking Beyond the Surface: endogenous federal institutions

A blooming literature on endogenous federalism and political unions develops this theme. If federal institutions and political unions are known to have discernible political and economic effects, actors must factor into their institutional preferences their expectations as to what these effects are, and what their relative position is going to be. Admittedly, they may get it wrong and make a choice on the basis of eventually wrong anticipations. But this does not imply that expectations do not matter for the institutional choice.

A prominent example here is the relationship between federalism, redistribution, and inequality (Bolton and Roland 1997; Dixit and Londregan 1998; Alesina and

¹⁹ See for instance a direct application of this framework to the analysis of the process of European integration in McKay 1999.

Spolaore 2003; Beramendi 2005, 2006; Wibbels 2005b). This line of research places the shape and territorial specificities of the distribution of income at the core of the analysis of the determinants of political integration, fiscal and political decentralization, and the changes of institutional arrangements in currently existing federations. This line of work contends that federalism and decentralization are associated with particular distributive outcomes not because they exogenously generate them, but because distributional concerns play a fundamental role in their selection and design.

In so doing, the literature on endogenous federalism and decentralization adds a new logic to more traditional explanations of the origins of federalism and decentralization, articulated around external threats and/or internal cultural and ethnic differences (Riker 1975; Lemco 1991; Panizza 1999; Stepan 2001). More importantly, it also complements more recent analyses of the logic of political and economic integration based on the need to design a more functional set of institutions to cope with the increasing mobility of factors, consumers, and taxpayers (Casella and Frey 1992; Casella and Weingast 1995). This is particularly the case in Mattli's (1999) account of regional integration. For Mattli, economic externalities explain the demand for integration, not its supply. In turn, for an effective supply of integration to emerge, pre-existing units must overcome a collective action problem motivated largely by distributional concerns. Thus, for regional integration to succeed, distributional concerns by potential losers of integration must be smoothed, or else they will have an incentive to renege. Hence, the key role of a dominant member willing to play the role of a "paymaster" to facilitate integration.²⁰

The issue of endogeneity is also at the core of the recent literature on the problem of stability in federations. Formal theorists have addressed this problem by trying to establish the conditions under which federalism becomes self-enforced. That is to say, the conditions under which federalism becomes an equilibrium in which both the center and the units see it as in their interest to meet their end of the contract (De Figueiredo and Weingast 2005). Bednar (2004, 2005) conceptualizes federalism as a very complex public good provision problem in an institutional environment particularly favorable to opportunistic behavior (including migration of authority for the *wrong* reasons). Opportunism, Bednar argues, can only be contained, not eliminated, through a set of complementary institutions designed to maximize compliance and minimize opportunism. Among these institutions, particular attention is paid to constitutional safeguards, the party system, and the judiciary (see also Bednar, Eskridge, and Ferejohn 2001). Each of these institutions covers different types of opportunism, thereby reinforcing each other's effectiveness. On their own, they are ineffective as guarantors of federal stability. While these analyses are very illuminating of the complementarities between different federal institutions, they do not address the conditions under which these stabilizing institutions are likely to emerge.

In contrast, Filippov, Ordeshook, and Shvetsova (2004) approach stability as a distributive conflict among electorally motivated elites. In so doing, they theorize constitutional limitations as endogenous to the nature of partisan competition.

²⁰ The expansion of Structural and Cohesion Funds in Maastricht would provide an example of side payments to potential losers of the process of economic integration.

Mobilization against the institutional core of the federation is contained where an integrated party system creates political and distributional incentives for political elites to channel their demands within the system. In contrast, when political competition is vertically and horizontally unstructured, conflicts about who gets what quickly evolve into conflicts about the rules of the game. Under such circumstances, economic and political crises are the likely outcome, for political competition exacerbates ethnic divisions and economic differences rather than muting them. Thus, the party system operates as a mechanism that, in the face of social, ethnic, and economic basis for political conflict, ultimately contributes to either the persistence or the collapse of constitutional rules. Yet, an additional difficulty comes from the fact that party systems themselves are endogenous to both the structure of the state and the cleavage structure within which they operate.

On the basis of a comparative analysis of Latin American federations, Diaz-Cayeros (forthcoming) provides additional evidence of the difficulties of detaching institutional choices, electoral concerns, and distributive politics. His innovative analysis of the institutional dynamics of the Mexican federation reveals that the centralization of the party system and the centralization of tax policy are jointly endogenous. In this and other Latin American cases, centralization of tax policy emerges as the outcome of bargain with local political elites. The key to the process was to allow rich regions to become richer while using centralized redistribution to buy off the support of the leaders of backward regions. This coalition between leaders of rich and poor regions alike, Diaz-Cayeros argues, was forged through the articulation of a national party system.²¹

Considered more generally, the recent literature on endogenous federalism and decentralization reverses the conventional causal line from outcomes to origins, and suggests that the observed association between federal institutions and certain outcomes responds to a process of historical self-selection. This is particularly the case when analyzing the relationship between federalism, decentralization, and income inequality, but a similar logic can be extended to different realms (Srinivasan and Wallack forthcoming; Aghion, Alesina, and Trebbi 2004). This poses a major methodological challenge. If, at least in part, federal institutions (and their effects) are self-selected, does federalism really matter? Or, to put it more moderately, when can we argue that the impact of federalism is exogenous as opposed to the outcome of a process of self-selection? Providing an answer to this question is the biggest challenge to be confronted by the comparative political economy of federalism in the years to come. I turn now to discuss alternative ways in which this challenge can be addressed.

3.3. The Way Ahead

How to cope then with issues of endogeneity and selection when analyzing the origins and consequences of federalism? A first, rather radical, take on the issue

²¹ Adding further layers of complexity to the causal relation between fiscal federalism and party system, Chhibber and Kollman 2004 have exploited the experiences of Canada, India, the United States, and the United Kingdom to argue that fiscal and administrative centralization is an important cause behind the centralization of the party system.

would be to argue that whenever institutions are endogenous, their effects are self-selected and, therefore, essentially irrelevant. Insofar as federal institutions reproduce the underlying tastes of the relevant political coalition, they do not really matter *per se*. In addition, the identification of exogenous effects of federalism would prove a Herculean task in that, as follows from the literature on endogenous fiscal decentralization or political parties, there are simply no good instruments. Through a different route, we would revisit the early, and rather disconcerting, Rikerian assessment on the significance of federalism (Riker 1964).

A second, less sanguine approach to the problem would be to distinguish different levels of institutional analysis, and assume that some are more likely to be exogenous than others. The process generating federalism is clearly multidimensional. This chapter has identified a number of factors relevant to the origins, dynamics, and consequences of federalism that operate at three levels: external environment (ethnoterritorial mobilization, income distribution), constitutional institutions and structures (state's rights, judicial review), non-constitutional institutions (party system, fiscal federal arrangements), and the actual degree of fiscal, political, and administrative decentralization. Certainly, not all these dimensions are moving simultaneously across space and time. Judicial review may help rewrite the constitutions on particular matters, but the apportionment of seats in upper chambers remains fixed (even if sometimes challenged by a minority) during long periods in the history of federations.

Being at the mercy of history (Przeworski, this volume), this lack of simultaneity leaves one window open to call partial equilibrium analysis to the rescue. An important implication of this chapter is that a general equilibrium theory of federalism is out of reach. Given the dynamic, bidirectional nature of the interplay between federalism and its environment, partial equilibrium analysis of the origins and effects of specific aspects of federalism seems to be a much more realistic and promising goal. By that I mean to exploit long-term, dynamic processes to isolate moments in which some dimensions of the problem are fixed while others (those of theoretical interest) vary. The leading intuition here is to go down the road of history in search of good instruments, that is of causal factors that lead to the adoption of federalism (or some dimension thereof) but remain genuinely unrelated to the effects federalism brings about. Insofar as it is possible to establish that the adoption of federalism or decentralization at time t is unrelated to societal, political, or economic conditions that can be taken for outcomes of federalism itself at time $t+n$, a solution to the problems of endogeneity and self-selection appears on target.²²

²² For instance, arguing beyond the classical insistence on the need for an "amalgamated security community" (Deutsch 1957; Lemco 1991), Ziblatt 2006 sees federalism as a compromise resulting from previously institutionalized, highly infrastructural political entities being able to resist coercion by larger-scale political units. In turn, O'Neill 2005 interprets state decentralization as the outcome of electoral calculations of vote-maximizing political elites at the national level. According to her, political decentralization "is most likely when the party in power believes it cannot hold on to power that is centralized in the national government but believes it has a good chance of winning a substantial portion of decentralized power through subnational elections" (2005, 5). Decentralization is then essentially an electoral strategy for parties with a long-term political perspective. Thus, insofar as electoral or geopolitical considerations actually drive the adoption of federal institutions, there is room to consider their effect on social and economic outcomes potentially exogenous. In contrast, to the extent that electoral and coalitional concerns overlap with distributional expectations, electoral strategies are no longer exogenous.

In the quest for these *moments of exogeneity*, the identification and analysis of external shocks is a promising strategy. For instance, in assessing the impact of the distribution of income on existing fiscal federal arrangements, one should look for cases in which a sudden transformation of the distribution of income is unrelated to the distributive effects of existing federal arrangements. In this sense, the impact of the Great Depression on North American federations, or the impact of Reunification on Germany's fiscal constitution, are two historical junctures that qualify as *moments of exogeneity* where the impact of a transformation of the distribution of income on federal institutions can be cleanly analyzed.

More generally, to provide a credible case, these moments of exogeneity ought to be properly identified, both theoretically and methodologically. Theoretically, this will require to continue with the blending of formal models of federalism with the taste for institutional complexities that characterizes the comparative politics of federalism.²³ In so doing, the multidimensionality of federalism becomes an asset worth exploiting.²⁴ Yet, to move on, a fundamental premiss ought to be accepted, namely that the fact that any given aspect of federalism is endogenous (or even self-selected) does not necessarily mean that over time it cannot generate consequences on its own. On the basis of this premiss, the relationship between the different elements of federalism among themselves, as well as with their environment, can be theorized by imposing the assumption that the other factors/dimensions are given. Recent examples of this way of proceeding include Alesina, Angeloni, and Etro's (2001), Hafer and Landa's (2004), and Volden's (2005) analyses of the joint provision of public goods in federations, Diaz-Cayeros's (2004) analysis of the impact of federalism on tax centralization, or Beramendi's (2006) study of the interplay between inequality and the representation of regional interest as determinants of fiscal decentralization. The real hurdle, however, lies in the need to set up a research design befitting the assumptions on the basis of which the theoretical relationship of interest has been identified. This brings us to methodology, where there is no perfect solution.

The best, if not the only, bet is to move away from imperfect designs through alternative routes, and hope that they all lead to the same end. Moments of exogeneity can be found in carefully constructed historical case studies, where different assumptions about what can be considered as given can be discussed in detail. But these can only complement (not replace) inferences made on the basis of a more general and systematic evaluation of the evidence. In this spirit, the quantity and quality of existing datasets on federalism and decentralization call for dramatic improvement. Despite all the progress made, the field still works with clearly contestable measurements of party system

²³ The synergies between the more normative models of market-preserving federalism and the development of comparative research on the fiscal effects of fiscal federal arrangements provide already a very good example of the benefits to be gained from breaking these boundaries. Interestingly enough, after challenging the limited applicability of market-preserving federalism, the comparative empirical literature on federalism has come to show that when the actual design of federations matches the assumptions of the model, it is indeed the case that economic outcomes are better.

²⁴ For instance, Falleti 2005 shows that the dynamic sequence in which different types of decentralization (fiscal, political, administrative) condition each other shapes in important ways the actual structure of power within federations.

integration, fiscal decentralization, or ethnic fractionalization, to name only a few key variables. Only by expanding the quantity and quality of data over time and space will it be possible to check the robustness of empirical findings to different assumptions about the process of generation of observables (Przeworski, this volume). In this way, theoretical and empirical advances complement each other in detaching the impact of the different dimensions of federalism from either their original causes or the conditions that shape their evolution over time. Otherwise, failure to accumulate better data will prevent scholars from providing solid answers to the leading questions in the field, thereby rendering theoretical advances an incomplete and ultimately fruitless effort.

4. CONCLUSION

The overview of the comparative politics of federalism leaves us with a paradox. While our knowledge of the workings of the different aspects of federalism and federations has expanded vastly over the last two decades, the long bemoaned goal of developing a general theory of the causes and consequences of federalism seems more of a challenge than ever. As federalism becomes less of a black box, the challenge of developing a theory able to predict both the emergence of federations and the nature and direction of its effects appears ever more gigantic.

Existing findings support conditional and probabilistic as opposed to deterministic statements on federalism and decentralization. Federalism and decentralization *per se* provide no magic recipe to ensure political integration or economic prosperity. Sometimes they do and sometimes they do not. In turn, this speaks to more normative concerns. The recent literature on federalism leaves no space for any federal illusion of any kind.²⁵ The more scholars find out about federalism and decentralization, the more cautious they become in predicting their effects or advocating their adoption. After formally highlighting the complexities involved in decentralizing government, Treisman (forthcoming) goes as far as to conclude that “decentralizing government in a particular place and time is very much a leap in the dark.”

Admittedly, a good deal of the nuts and bolts of federalism and decentralization remain in the dark. But precisely for this reason it is much too early in the game to mix up the need for further insights on how federalism plays in different contexts with the impossibility of making reliable claims about the likely effects of political decentralization (or integration, for that matter). In other words, context-conditionality does not necessarily mean lack of predictability. Likewise, launching a plea for caution does not imply proclaiming an inability to engage in informed constitutional engineering. Instead of giving up that possibility altogether, a more promising route for the

²⁵ However, this should not be confused with a vindication for centralization. Even where federalism is not associated with better economic outcomes, a more centralized system might not constitute a better option given high levels of cultural, economic, and political heterogeneity.

comparative politics of federalism in the years to come is to take on the challenge of systematically disentangling the links between the specifics of the design of federations and the economic and societal conditions surrounding them. This will require both *fortuna* and *virtu*. The former is up to history and its will to provide us with enough moments of exogeneity. The latter is up to us and our ability to find the right combination of analytical tools.

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