



Stanford

Center for International
Development

Working Paper No. 158

**Federalism, Decentralization, Globalization, and Economic
Reforms: Some Issues by**

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August, 2002



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1. INTRODUCTION

1.1 **Federalism and Decentralization: The Literature**

Federalism and decentralization are emerging as important policy issues in many countries and in international institutions. Economists and political scientists (Breton and Scott (1978), Weingast (1995), Breton (1996), Musgrave (1959), Oates (1972)), have long been concerned with the theory of fiscal federalism, by which is meant a “general normative framework for the assignment of functions to different levels of government and the appropriate fiscal instruments for carrying out these functions” (Oates (1999)).¹ The functioning of fiscal federalism in many developed and developing economies has been analyzed as well (Ter-Minasian (1997), Walsh (1992)). There is also a large literature on the related topic of decentralization in a broad sense, including delegation of rights and responsibilities from one level of government to another, deconcentration and devolution (Manor (2000), World Bank (1999), Dethier (2000), Tanzi (2000)). Political and economic corruption has been identified as a barrier to development as well as transition to a market economy and democratic polity. Some expect decentralization to reduce corruption while others see decentralization as contributing to increased corruption. The problem of governance in the public and private (corporate) sectors, which subsumes corruption, has drawn the attention of multilateral financial institutions such as the International Monetary Fund (IMF) and the World Bank (IMF (1997, 2000), World Bank (1994)).

1.2 **Assumptions of Conventional Analysis**

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First, most of the conventional theory of fiscal federalism and the analysis of its practice assume an essentially closed economy. Second, the works generally assumes that a functioning administrative apparatus exists at all levels of government and that political control over the apparatus is determined through some participatory democratic process such as periodic elections. The discussion of the impact of the decentralization on corruption obviously recognizes that decision makers (politicians and bureaucrats) are more often driven by private gains in their choice of policy actions than by considerations of social welfare, but the broader literature on federalism tends to assume away corrupt behavior on the part of any of the relevant actors. It does, however, take into account differences among jurisdictions with respect to information administrative capabilities, preferences of individual citizens over their consumption of private and public goods, and preferences of policy makers in different levels of government over equity, efficiency and political support. Third, conventional analyses are static with an unchanging economic environment. In particular, unchanging technologies of production, exchange, transportation, communication, and administration are often assumed.

1.3 Proposed Research: Points of Departure

The proposed research will go beyond conventional analysis in several ways.

First, the economy will be assumed to be significantly open to international trade in goods and non-factor services. We will assume differing degrees of openness to factor movements, with the extent of openness being greatest with respect to capital (short term, long term, debt as well as equity, and direct investment) and least with respect to unskilled labor.

Second, the analysis will focus on the short to medium run rather than on the long run. We will not place so much emphasis on the steady-state equilibrium, but on the transition towards equilibrium. This in turn implies that the analysis has to allow for evolving economic, social, and political environments, including, in particular, technological change.

Third, we will examine how federal states address new policy challenges that arise as countries increase the role of markets in the allocation of resources. Including the private sector

in the production and provision of services (even in sectors such as utilities that were once deemed natural monopolies to be owned and operated by the state) is one such area of reform that creates new governance challenges. Goods and services produced by these sectors are not often traded internationally, and since the domestic market cannot accommodate many producers in many countries, an appropriate domestic regulatory system must be established in order to prevent non-competitive behaviors. The actual and ideal organization of the system and the parts to be played by different levels of government of a federal state in regulation are important new issues for research.

Fourth, the political economy of decentralization will be explored in societies in which opportunistic or corrupt behavior of private individuals, firms, as well as functionaries at various levels of government is widespread.

1.4 Proposed Research: The Context

The context for departing from received knowledge on federalism and decentralization arises from four ongoing processes that are operating almost everywhere but at a greater pace and intensity in developing countries. First is the process described by the cliché globalization. It involves integration of world markets through reduction of national barriers at the border for trade in goods and services and for flows of factors across borders. Globalization in goods and services trade has been facilitated by the Uruguay Round agreement, the latest of several multilaterally negotiated agreements for the reduction of trade barriers under the auspices of the General Agreement on Tariffs and Trade (GATT). The agreement replaced GATT with a new institution, the World Trade Organization (WTO), which embodies a rule-based system for trade relations among members and a strong dispute settlement system for ensuring compliance.

Second, and no less important than globalization, is the process of economic reform. It involves considerable reductions in barriers to foreign trade and investment and major changes in the extent and scope of government intervention in the domestic economy. Some of the most prominent of these changes are (i) sale of equity in or outright privatization of state enterprises;

(ii) reform of tax and expenditure systems consisting of expansion of the tax base, rationalization and reduction in the number of tax lines, tax rates, and subsidies, as well as replacement of some taxes by others that are less distortionary (e.g. replacing cascading sales or excise taxes by value added taxes); (iii) moving from price controls and rationing to a system of user charges for publicly provided goods and services; (iv) improvements in the existing social safety nets and creation of new ones; and (v) institutional reform, such as the reform of legal and administrative system. This last area of reform covers a large agenda, ranging from greater decentralization of governance with concomitant devolution of power and resources and greater transparency in decision making at all levels of government to accountability and reform of the financial sector, including greater independence of the central banks from finance ministries in the formulation of monetary and exchange rate policy.

Third, the process of domestic political reform, especially but not exclusively democratization, impacts the political-economic environment for federalism. Expectations about the process of international policy-making have changed as well. There is a growing current of protest that national sovereignty over policies (e.g. environmental policies) is being usurped by “unelected” intergovernmental government agencies such as the WTO, the IMF and the World Bank. In trying to assuage protestors’ fears, and thus ensure that they do not threaten the liberalization of trade and financial flows, the agencies themselves are engaged in a process of bringing about greater transparency in their own decision-making and also involving non-governmental groups as observers in some their meetings.

Fourth, the information technology (IT) revolution’s effect on the economy is another factor to consider in analyzing federalism. The potential for sustained productivity gains from the diffusion of IT throughout the economy is well recognized. More generally, private individuals and businesses’ costs of transacting with governments at all levels as well as society’s cost of running the government (particularly in the health and education sectors) could decrease significantly. Corruption could be reduced because of an ease of communication and greater transparency made possible by the use of IT. The diffusion of IT also enables any new market and other information to spread across the globe almost at the same instant it becomes known.

This means the time available for public and private decision makers to absorb and react to new information has been drastically reduced. Clearly this could impart greater instability to markets, particularly financial markets and increase the frequency of contagious financial crises.

It is evident that the processes of economic and political reform are more salient for developing countries than for developed. Nevertheless, the increasing importance of cross-border capital and trade flows suggests that these reforms, including decentralization, must take international reactions into account. First, developing countries have a vital interest in ensuring that access to markets in developed countries for their goods, services, and factors is not hindered. Second, since private capital flows are far greater than loans and grants from bilateral and multilateral sources, policy makers in developing countries have to be sensitive not only to possible reactions of foreign investors to any contemplated change in policies, but also to the fact that credibility (or lack thereof) and reputations also matter. Third, even in organizations such as the WTO whose articles of agreement do not formally assign greater weight to the rich countries in their decision making, developing countries cannot achieve much without the support of rich countries who are the major actors in the world trade arena.

2. FRAMEWORK AND ISSUES OF PROPOSED RESEARCH

The proposed research will be under taken in a comparative framework involving two developed countries (Australia and Canada)² and five or six developing countries (Argentina, Brazil, India, Mexico, Nigeria, and China). The chosen countries differ substantially in their socio-economic-political institutions, their stage of development, and the extent of external openness. As Wildasin (1997) points out, such diversity provides opportunities as well as difficulties for drawing useful inferences from a comparison of the countries' experience with

² Understanding the evolution of federalism and its functioning in these two mature federations that are already well integrated with the world economy, and comparing them with the ongoing process of federalism and global integration in the other project countries, would be very valuable.

fiscal decentralization, relations between governments at various levels as well as the interaction between openness and decentralization.³

The first component of the proposed research is primarily descriptive. It will document the current state as well as the evolution of federalism through constitutional mandates, unwritten (but respected) conventions, legislative enactments and administrative practice in each country of:

(i) The form of government (presidential, parliamentary, form of legislature), levels of government, procedures for appointment and training of bureaucracy, as well as political organizations and mechanisms for the participation of the general population in choosing leaders of government at various levels.

(ii) The fiscal structure, including assignments of tax bases and responsibilities for tax collection, arrangements for revenue sharing and transfers between levels of government, as well as expenditure assignments.

(iii) The levels of government that are permitted to borrow from domestic and international capital markets as well as from multilateral institutions, and restrictions on the exercise of borrowing powers such as a requirement of the federal government's consent before any sub-national unit can borrow or negotiate loans from multilateral banks.

(iv) The degree of openness to foreign trade, investment and technology. This includes a description of the exchange rate system, external debt, restrictions, if any, on the exercise of borrowing, foreign direct investment in green field and joint ventures, as well as which levels of government that are allowed to impose and or enforce the restrictions.

(v) The extent of the involvement government (at each level) in the production and provision of goods and services.

The second component, again descriptive, relates to economic performance in terms of aggregate GDP growth, inflation, foreign trade and investment, poverty and income distribution and adjustment to any major economic and political shocks. With these two descriptive components setting the stage, the third component will address a number of substantive questions

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and hypotheses. These could be grouped under the following heads: (i) Federalism, Globalization, and the Macroeconomy; (ii) Privatization, Regulation, and Decentralization; (iii) Factor Mobility within and between countries; and (iv) Political Economy.

2.1 Federalism, Globalization and the Macroeconomy

Decentralization is usually regarded as contributing to macroeconomic instability through several mechanisms. Clearly, an efficient response to shocks that affect several sub-national units or entire national economy becomes considerably more difficult if the responsibility for implementing the appropriate policies is vested in large part in sub-national governments. It would be time consuming to achieve adequate coordination of policies of sub-national governments and ensure that policies of national and sub-national governments at least do not counter act each other in responding to shocks. Another source for macroeconomic instability is that the central government would rarely be able to commit itself not to bail out lower level governments if they accumulate unsustainable levels of debt. One consequence of the lack of commitment is the softness of budget constraints of lower level governments. If the debt accumulated by sub-national governments is in part seen as contingent liabilities of the central government, financial markets might correctly anticipate a future bail-out by the central government of sub-national governments even if the central government's own liabilities appear sustainable given its revenues. If the central government's ability to service its future liabilities (its own as well as those arising from anticipated bail-outs) is seen by the markets as limited, then at least a rise in the cost of borrowing, and possibly even a financial crisis would result.

There is a consensus in the literature that monetary and exchange rate policies should be the exclusive responsibility of the central government. It is also held that highly income elastic taxes and counter cyclical expenditures should also be in the hands of central governments. However, this literature is concerned mainly with fully monetized economies in which wage and salary employment is the dominant mode of employment and income and payroll taxes, rather than indirect taxes such as customs and excise duties, are the major sources of revenue. The

diversity among the countries included in the project in these dimensions provides an opportunity to analyze the interaction between macroeconomic stability and decentralization in a broader context.

Comparisons between countries studied in this project highlight such differences. India, for example, is at one extreme. A significant part of GDP is still not marketed, investment is commonly financed through own savings rather than from savings of others through financial intermediation, self-employment in one's own farm or household and informal enterprises rather than employment for wages and salaries is the dominant source of employment, and income (personal and corporate) taxes are levied on a very narrow base and account for a relatively small part of the tax revenue of all levels of government. The other extremes in these dimensions are Australia and Canada. The salient policy issues are likely to vary across countries. Growth instability and inflation may be far more important policy issues than smoothing cyclical fluctuations for India and some of the other project countries.

The research questions that will be explored in each country include:

- (i) Are there formal institutional constraints that are meant to impose "hard" budget constraints on different levels of government? What are they? Are there ways in which such formal constraints can be and have been circumvented? Formal constraints on government borrowing can be circumvented, for example, if lower level governments own or can create corporate entities that can borrow from the market as is happening in India.
- (ii) In the absence of formal constraints and in the face of the inability of central government to commit credibly to a non-bail out policy, are there ways in which fiscal discipline can nonetheless be ensured? For example, party discipline could substitute for formal constitutional constraints and credible commitments if the same political party controlled the sub-national and national governments. This was apparently the case in Argentina in some periods and in India during the prime ministerships of Nehru and Mrs. Gandhi. By the same token, if as in contemporary India, the national government is ruled by a coalition of regional parties and a national party has strength in some but not all regions, is fiscal discipline among regions difficult to achieve? Are devices, such as a balanced budget amendment to the constitution as was once

debated in the U.S., and legislation such as the Fiscal Responsibility Act currently being considered by the Indian Parliament, likely to be credible commitment devices? If they are, is there a significant trade-off between enhanced fiscal restraint and ability to respond effectively to shocks?

(iii) Quality and adequacy of economic infrastructure (power, transport and communication) and of human capital have been identified as important prerequisites for enhancing competitiveness in world markets and attracting foreign investment. In many developing countries (including some of the project's countries), the government is the major, if not the only, provider of and investor in infrastructure and educational devices. The degree of involvement by different levels of government varies across countries in each of these activities. Also, as part of ongoing economic reforms, some developing countries are reducing government involvement in these sectors through sale of equity to private investors or outright privatization. The implications of alternative assignments of responsibilities for education and infrastructure among levels of government for external competitiveness and for attracting foreign capital as well as for the efficiency and equity of access to services is an important area for research. The implication of private sector involvement in service provision is another.

2.2 Privatization, Regulation and Decentralization

The traditional arguments for centralized provision of public goods are that spillover effects from one sub-national unit to others and other externalities could be internalized and scale economies could be exploited. However, the costs of acquiring the needed information and monitoring could be high for central authorities. Decentralized provision of public goods is assumed to exploit the advantage local authorities have in being better informed about diversity of local preferences for public goods. Local officials may also have better information with which to identify cost minimizing ways of meeting local needs. These traditional arguments about the costs and benefits of centralization versus decentralization assume that the relevant goods and services will be provided by the public sector. Recent experience and technological

developments suggest that many public sector activities, including the provision of public goods, could be transferred to the private sector.

For example, a national private enterprise could provide services and internalize any scale economies, interregional spillovers and externalities in their production. The demand for the services will reflect local tastes and needs, while the private supplier will have the incentive to minimize the cost of meeting these demands. Thus privatization is a third alternative to centralized and decentralized public provision and is being adopted in some countries.

Financial concerns have also prompted privatization of state-owned enterprises (SOE) in some developing countries. For various reasons, including inefficiency of their operation and subsidized sales of their output to politically powerful groups, many SOEs are either virtually bankrupt or cannot raise the resources needed from retained earnings or from the capital market to finance their expansion to meet growing demand. In India, for example, state-run electricity boards of most states incur enormous losses both because of subsidized sales (in some states farmers are supplied free electricity) and because of theft. Without a reliable supply of power at reasonable costs, accelerating GDP growth and sustaining a more rapid growth is impossible. India opened the power sector for private sector investment after the reform of 1991.

The efficiency gains expected from privatization would be realized only if the operational control of the SOE is transferred to private hands and if there is adequate competition for the privatized enterprise. Adequate competition often cannot be ensured, especially in sectors such as electricity transmission, railways and telecommunication in which network externalities, lumpiness and long gestation lags in investment are significant. Political economy issues may also impede efficient outcomes: in India, for example, outright privatization is still a political taboo and “disinvestment,” or sale of part of the equity in SOEs without transfer of control, is still the preferred option. In these situations an appropriate regulatory framework is necessary for protecting the interests of the users without adversely affecting the incentives of suppliers to meet current demands of users and also to invest in capacity to meet future demands.

The experience with privatization in the transition economies and with deregulation of formerly regulated utilities in developed countries (e.g., deregulation of electricity and its

aftermath in California) suggests that the process adopted for privatization and deregulation could affect outcomes. For example there are alternative modes of selling an SOE to private buyers. These include: sealed bid auction for the sale of the whole enterprise, distribution of vouchers of ownership in an SOE to all citizens who later sell them for cash to those who wish to operate the enterprise or sale of a part of the equity in the SOE to private agents as in Indian style disinvestment. Deregulation could be complete involving, for example, generation, transmission and distribution of electricity or partial as in California where retail consumer price was controlled while wholesale producer price was left to be determined by market forces and long-term contracts between distributors and generators were prohibited. The facts that deregulation and/or privatization is ongoing in all the project's countries and that governments at more than one level are involved in the process provides an opportunity to draw analytical and policy lessons from comparing their experiences.

Workers in SOEs often see privatization as a threat to their continued employment. The possible entry of transnational enterprises with easy access to world capital markets and to modern technology into the deregulated sector threatens the continued viability of private and state-owned domestic enterprises. As such, considerations of political economy are also very important (see section 2.4 on political economy). Following is an illustrative list of issues for documentation and research.

(i) Description of the extent of privatization of SOEs in various sectors of the economy since the 1980s and the modes of privatization adopted, with particular emphasis on infrastructure and financial sectors.

(ii) Description of the type of state ownership by levels of government as well as the regulatory system in place or proposed to be put in place. In particular, sectors in which there is or will be a single regulatory authority for the whole economy and those in which more than one authority (perhaps a different one for each sub-national unit) would be distinguished.

State ownership and operation could also take different forms ranging from, at one end, ownership and operation of the SOE being vested in a line ministry or department with resources for investment and financial outcomes of operation being part of the department's budget, and at

the other end, the SOE being a corporate entity competing with private enterprises, with right of sale of equity and bonds in capital markets and paying dividends to the state on the equity held by the state.

The variance in banking regulation, for example is an example of the type of diversity we would like to document. The Central Bank has traditionally been the sole regulator of commercial banks and a single national authority for regulating securities market is the norm, whether the authority is relatively recently established as in India or longstanding as in the U.S.A. The treatment of investment banks and the extent to which commercial banks could hold equity in other enterprises and are also permitted to engage in other financial services such as stock brokering, however, vary among countries. In some countries banks are prohibited from operating beyond their jurisdiction of incorporation through branches. Regulation of various types of insurance is another example of diverse practices. It is possible to have different arrangements of state ownership and regulation for different segments in the chain of production, transmission, distribution and final use.

(iii) Following descriptions (i) and (ii), normative issues will be explored. What are the considerations that need to be taken in account in determining whether there should be one or more regulatory authorities? If there are to be more than one, should there be one for each relevant sub-national jurisdiction or for each appropriately defined subset of jurisdictions? What are the relevant considerations for deciding whether privatization or deregulation should be complete or partial within an industry or sector? Are there any instruments that should be put in place to monitor the performance of regulators and to prevent regulatory capture and corruption? If more than one regulatory authority has oversight responsibilities of enterprises in the same jurisdiction, or if regulatory authorities of different jurisdictions oversee the same enterprise or activity, how best is coordination of the decisions of the concerned regulatory authorities to be achieved?

(iv) In sectors, such as electricity, in which more than one sub-national unit has regulatory oversight over an activity whose output is traded across sub-national units, investment in capacity is lumpy and involves long gestation lags (in part created by regulatory hurdles), and

in which activities of production, transmission through networks with externalities, and delivery to ultimate users can in principle be separately regulated, difficult problems of equity (across consumers within and between sub-national units) and efficiency may arise over the short and long run. What form have these problems taken and how have countries addressed them?

The current mess with electricity deregulation in California illustrates a range of problems that regulatory policy can create. First, high (relative to other states) regulatory hurdles apparently contributed to long gestation lags and relatively slower creation of additional capacity. Second, growth in demand at controlled user-prices outstripped capacity, creating a situation of growing excess demand, with no incentives on the part of users to conserve. Third, with wholesale producer prices deregulated and high excess demand, purchase prices shot up when supply from neighboring states fell due to exogenous adverse shocks such as low storage levels in hydroelectric dams. Fourth, private utilities that owned no generating capacity or had earlier sold off what they owned and had been precluded by law from entering into long-term contracts with suppliers, were caught between steeply rising purchase price and unchanged sale prices. They rapidly approached bankruptcy.

The lesson from California's experience is not that deregulation is necessarily inappropriate, but only that inappropriate deregulation could be costly. As such, it is important to consider the normative aspects of the design of regulatory systems for different sectors (and more generally competition policies) in a federal state.

(v) The Indian experience illustrates other issues that have to be analyzed as well. Unlike the USA in which suppliers in other states complied with the federal order to sell electricity to California, recently in North India there was a serious blackout for an extended period of time because suppliers in different states did not comply with the orders of grid managers. Thus the efficiency gains from electricity flows from one state to another through a grid can be ensured only if the participants in the grid from each state have the incentives not to engage in autarkic behavior. The Indian grid system is not the transmission mechanism of a well functioning market for electricity, but one in which administrative fiat, rather than market incentives, operates at all levels. Another unfortunate aspect of the Indian system is that

electricity producers have to sell their output to state electricity boards that distribute it to ultimate users. Many boards are nearly bankrupt. Understandably private investors would hesitate to invest without some assurance that they would be paid for their sales to state electricity boards. Since the state governments that own the boards are themselves in fiscal stress, a guarantee of payment by state governments does not prevent investors from demanding counter-guarantees from the central government. Although several states have established a regulatory authority for electricity, and some states have gone further in privatizing or corporatizing activities of the state electricity boards, it is fair to say that an integrated framework for the design of regulation, privatization, investment in transmission and grid formation and enforcement is lacking.

Regulatory design questions arise in other sectors, in particular in telecommunications and the financial sector. Poorly regulated and ill-functioning telecommunications could greatly reduce the potential productivity gains from the information technology revolution. As recent financial crises have shown, a poorly regulated domestic financial sector that has relatively easy access to external financial can be a recipe for disaster. It is also the case that a large bank is unlikely to be allowed to collapse if it is “too big to fail.” Knowing this, the bank may finance riskier activities than if the probability of rescue were negligible. A comparative analysis of the experience of the project countries on issues of regulatory design is a part of the proposed research.

2.3. Factor Mobility

The literature following Tiebout has analyzed the implications of free factor mobility across sub-national units for tax and expenditure assignments, provision of public goods and private investment. A basic finding of this analysis is that from an efficiency perspective decentralized levels of government should avoid non-benefit taxes (i.e. taxes that do not match the benefits received) on mobile factors. Not only should they refrain from non-benefit taxes, but they should also proactively engage in benefit taxation where the public sector provides benefits

to mobile factors (e.g. local public goods, local inputs that raise the productivity of mobile factors).

Equity, on the other hand, might require the use of non-benefit taxes. The efficiency argument above suggests that the federal government is in the best position to levy such taxes. To the extent the entire tax structure at all levels of government is not designed to achieve Pareto Optimality, and one level of government ignores the spill-over effects of its fiscal decisions on other levels, serious distortions can arise involving, for example, “exporting” of tax burdens, external congestion effects, and impacts on levels of revenues in other jurisdictions, as well as certain equity issues associated with a generally repressive pattern of tax incidence (Oates, 1999).⁴

Another important finding is that reliance on resident-based taxes, rather than source-based taxes, can lessen tax-induced distortions. There is a presumption for the taxation of relatively immobile factors.

Recognition of international mobility of factors raises several new issues from a development perspective. Resident-based taxation becomes even more complex administratively and beyond the capacity of most developing countries. Capital and skilled labor are more mobile internationally than land and unskilled labor. However, taxing land is out of the realm of possibility politically and taxing unskilled labor, which is the only asset the poor have in developing countries, is regressive. The proposed research will explore how to devise a tax structure that does not sacrifice efficiency too much to achieve equity, or vice versa, while recognizing the limited administrative capabilities and the opportunities opened up by globalization of capital and skilled labor. As Wildasin (1997) points out, “the opening of factor markets may limit the ability of governments to undertake redistributive policies. Conversely, erecting barriers to factor movement may entail efficiency losses while facilitating government policy interventions.”⁵ The ability of governments in developing countries to undertake redistributive policies other than through taxation-cum-transfer of factor incomes (such as through subsidized provision to subgroups of the population of food, irrigation water, and electricity) is

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also constrained by the concern about their effects on fiscal deficits and the related adverse effects of fiscal deficits on financial markets.

Competition for mobile capital and footloose industries raises issues that interact with aspects of federalism in essential ways. As noted in Section 2.1, if the federal government cannot credibly commit to not bailing out lower level governments, investors would look at the future as well as the current fiscal health of the federal government and take into account any contingent liability in the event it has to bail out state governments. In any case, there is a serious moral hazard problem: most federal governments will in fact bail out lower level governments, whether or not they have committed to doing so (another illustration of the “too big to fail” syndrome) and lower level governments, aware of this, have less incentives to be prudent. This is not simply a theoretical possibility: the deliberate default by a state government in Brazil contributed to that country’s macroeconomic crisis in 1998.

In the competition to attract FDI, sub-national units within a federal economy not only compete with each other but also with other national and sub-national units around the world. It has been suggested that the tools of this competition often go beyond the use of tax holidays and provision of subsidized land and infrastructure services, but also a lowering of environmental and labor standards. Such competition, so it is alleged, will inevitably result in a “race towards the bottom,” with an equilibrium in which the concessions offered by different units participating in the competition cancel each other, resources are transferred from tax payers to investors, the environment is polluted, and labor standards are lowered while the location decisions of the investors remains as they would have had there been no competition.

Research questions in this area would include:

(i) Documentation of the extent of mobility of factors within national borders and the inflow as well as outflow of factors from the country. To the extent data would permit, flows from and to each sub-national unit would be recorded. This would enable an examination of whether, for example, prior public and private investments in human capital and/or infrastructure are associated with factor flows. For example, emigration of educated labor from Kerala state in

India to West Asia and unskilled agricultural labor from Bihar and Eastern Uttar Pradesh to Punjab has been much higher than from other states. It would be interesting to explore to what extent the relatively superior human capital endowments of Kerala and poor endowments of Bihar explain these differences.

(ii) Documentation of tax and other concessions offered to foreign investors and whether these differed from those offered to domestic investors would be helpful to address the alleged race-to-the-bottom issue. As mentioned earlier, the equity and efficiency impacts of the existing fiscal arrangements and the potential improvement in them would be explored.

2.4 Political Economy

The political processes in the project countries have undergone significant changes in the last five decades of the twentieth century. All of them are currently democratic in the sense that the governments in control attained power through some democratic process. But they have not always been democracies with governments elected through universal franchises. India became an independent country in 1947, adopted a republican constitution with strong unitary features in 1950, and has had periodic elections at the central and state levels, though not at lower levels. Except for a brief flirtation with authoritarianism during 1974-76 by the then Prime Minister Mrs. Indira Gandhi, the country has remained a vibrant democracy with firm civilian control over the armed forces. Argentina and Brazil have long been independent, but military dictatorships and democratically elected regimes have alternated. Except for brief interludes, military dictators have ruled Nigeria.

Besides the diversity of the changes in the overall political process, there is also diversity in the extent of decentralization and in trends in the party composition of governments at various levels as well as in the incidence of dissident and secessionist movements. For example, India started at independence in 1947 with one party ruling (the Congress Party of Gandhi and Nehru which fought for independence from British rule) at the Center and the states, with Nehru as the Prime Minister of the country. Even before Prime Minister Nehru's death in 1964, the Congress

Party lost power in some states (e.g. Kerala). After Mrs. Gandhi became Prime Minister in 1966, she split the Congress Party twice and more states came to be ruled by other parties and coalitions. Still, except for 1977-1980 and 1989-91, the Congress Party ruled at the Center until 1996. Varying coalitions of regional and national parties have been ruling at the Center since then and many states continue to be ruled by parties not in the central coalitions. Also, the 73rd and 74th amendments to the constitution of 1993 added a third tier of governments at the local level. Although such governments existed before, the amendments mandated periodic elections and assigned certain governance functions to them and also set up a formal mechanism at the state level to determine devolution formulae for providing adequate revenues for them to carry out their mandates.

These differences have implications for the ways that subnational governments interact with each other as well as the central government. The fact that governments are elected through free elections does not imply all differences among the citizens are resolved peacefully through democratic processes. India, for example, is fighting armed dissidents, not only in Kashmir, but also in Assam and other northeastern states. Nigeria is also beset with dissidence and fought a civil war in its Biafra region in the past and there are continuing tensions between the predominantly Muslim northern region and Christian South.

Decentralization of political and economic power has been viewed also as a means to defuse ethnic, religious or other conflicts in large federal states with a diverse population. In fact, after a violent agitation in favor of such a division, India was divided into states in each of which an overwhelming majority of the population spoke the same language. If the benefits of crisis diffusion and those arising from informational advantages of local provision of public goods outweigh any economies of scale and other benefits of centralization, and problems of governance including costs of central coordination in large federal states are large, then an argument can be made in favor of breaking up large federal states into small countries. Indeed there is a related literature on size of nations and possible trade-offs of benefits of economic integration and political disintegration (Alesina and Spolaore (1997), Alesina et al (2000)).

Recently the question of whether or not all federal structures are equally capable of sustaining a market economy has received analytical attention. It is argued that only certain forms of federalism, fulfilling the requirements for “market preserving federalism” (MPF), are capable of sustaining a free competitive market economy (Weingast (1995)). The essential assumptions underlying MPF are that the federal government insures that goods and factors are mobile across sub-national jurisdictions, there is limited revenue sharing among levels of government and access to capital markets is limited for all levels of government. With the federal government having monopoly over money creation, the constraints on access to capital markets limit the ability of sub-national governments to borrow. Taken together, these assumptions imply that governments at all levels face a hard budget constraint.

The policy environment has to be stable for markets to function efficiently and market participants to undertake long-term investments essential for development, which in turn means that the commitment of governments not to surprise markets with adverse policy changes must be credible. The policy environment includes, notably, a governance structure based on the rule of law, well-defined and secure property rights, and an enabling framework for entering into mutually beneficial contracts without having to incur excessive transactions costs, particularly for their enforcement.

The assumption of MPF that the sub-national units face hard budget constraints appears central to the analysis. Establishing credible commitment to a no-bailout policy (without which imposing hard budget constraints on sub-national units is virtually impossible) is further complicated if national and sub-national governments are controlled by different parties or coalitions with different objectives. The party in power at the federal level could, at best, with strong party discipline, force the governments in those sub-national units in which it is in power to go along with its wishes. But obviously this is not enough. In any case strong discipline is not a characteristic of political parties in developing democracies.

The issue of governance, which in large part is related to political and administrative corruption, has received a lot of attention from multilateral development agencies such as the World Bank and UNDP, foreign aid agencies in developed countries, and non-governmental

organizations as well as from growth economists. While there is agreement that the extent of government involvement in the economy and the degree of centralization influence the level of corruption, there is no consensus on whether decentralization of economic decision-making reduces corruption.

The political economy issues that this project will explore include:

- (i) The implications of diverse forms of government, number of political parties and the possibility of different parties or coalitions governing at the federal and sub-national levels on fiscal discipline, privatization, competition for foreign capital and direct investment.
- (ii) The effects of decentralization on governance, conflict resolution and functioning of markets.

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