The Theory of Comparative Federalism and The Emergence of Economic Liberalization In Mexico, China, and India

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1. Introduction

Why do federal systems perform so differently? Consider: For the last three centuries, the richest nation in the world has always been federal. The Dutch Republic from the late sixteenth through mid-seventeenth centuries, England from the late seventeenth or early eighteenth and mid-nineteenth centuries and the United States from the late nineteenth and throughout the twentieth century. Similarly, modern China, a de facto federal state, has also experienced sustained growth. In contrast, India, the large Latin America federal states of Argentina, Brazil, and Mexico, and modern Russia have all fared much more poorly. How do we account for such large differences in economic performance?

The first observation to make is that federalism is not a single system with one type of tendency. Federalism is instead a category of systems whose political and economic properties vary

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widely. It therefore seems inappropriate to speak of the tendencies or properties of federalism per se, as so often occurs in the literature. Some federal systems may promote economic growth or macroeconomic stability while others do not.

In section 2, I develop a theory that allows us to explain and predict differential federal economic performance. The theory provides an explanation of why some federal systems grow so rich, sustaining the richest economy in the world, while others remain poor and exhibit low growth. Section 3 briefly discusses a range of cases.

I next apply the approach to three cases of emerging markets out of traditional systems, all of which intimately involve federalism in their strategies for development: China, Mexico and India. Section 4 discusses the rise of PAN in Mexico, and section 5 then compares Mexico with China and India.

2. A Comparative Theory of Federalism

To understand the comparative theory of federal performance, I develop a set of conditions that help differentiate among federal systems. All federal systems decentralize political authority, so a clear necessary condition for federalism is: (F1) there exist a *hierarchy* of governments with a *delineated scope of authority*.

Yet federal systems differ enormously in how they allocate power. The following conditions characterize how federal states allocate power among national and subnational governments.

(F2) **Subnational autonomy.** Do the subnational governments have primary *authority over the local economy*?

(F3) **Common market.** Does the national government have the authority to police the *common market*?

(F4) **Hard Budget constraints.** Do all governments, especially subnational ones, face *hard budget constraints*?

(F5) **Institutionalized authority.** Is the allocation of political authority *institutionalized*?

To make this discussion manageable, I will ignore many subtleties and simply assume that each condition either holds or not.[1] We can thus characterize different federal systems as to which conditions they satisfy, ranging from F1 alone to F1 and some of the others to F1-F5.

I first consider an ideal type of federalism that satisfies all five conditions called *market-preserving federalism*, (see Weingast 1995). In combination these conditions help foster and preserve markets.

The logic is as follows. Conditions F2 - F5 limit national power to the task of policing subgovernmental encroachment on the common market and to providing national public goods, such as defense and a stable macroeconomic regime. Power to regulate markets is reserved for the subnational governments (F2). Competition among lower governments compete for factors of production and tax revenue limits the discretionary authority of these governments. Jurisdictions that

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[1]For further details, see Montinola, Qian, and Weingast (1995) and Weingast (1995).

fail to foster markets risk losing capital and labor and hence valuable tax revenue. A necessary condition for this competition to be beneficial is the absence of trade barriers. Without F3, each subnational government would become a *de facto* "national government" in its jurisdiction, short-circuiting federalism's limits on lower governments.

A hard budget constraint (F4) concerns fiscal transfers among levels of governments and government borrowing (see McKinnon 1996 and Wildasin 1997). Under this condition, the federal government cannot bail out states that go into deficit due to fiscal imprudence; and it prevents states from endlessly bailing out failing enterprises. A hard budget constraint does not limit fiscal transfers to poorer regions, however; but it does constrain how and under what circumstances fiscal transfers are made.

Condition F5 provides for credible commitment to the federal system. This condition requires that, beyond simple decentralization, the federal structure must not be under the discretionary control of the national government. The absence of this condition allows the national government to compromise subnational government autonomy and hence the benefits from competition among them.

A critical feature of market-preserving federalism is that it limits the exercise of arbitrary authority by all levels of government. Federalism limits the central government directly by placing particular realms of public policy beyond that government's reach. For lower governments, constraints are imposed in two ways. First, the central government polices state abuses of the hierarchy, such as encroachments on the common market (F3). Second, the induced competition among lower jurisdictions places self-enforcing limits on these governments' ability to act arbitrarily (Tiebout 1956, Rubinfeld 1987).

No government has a monopoly of regulatory authority over the entire economy, so no government can create monopolies, massive state owned enterprises, solely to provide jobs or patronage, and other forms of inefficient economic intervention that plague developing countries. A subnational government that seeks to create monopolies or a favored position for an interest group places firms in its jurisdiction at a disadvantage relative to competing firms from less restrictive jurisdictions.

Competition also induces subnational governments to provide a hospitable environment for factors of production, typically through the provision of local public goods, such as establishment of a basis for secure rights of factor owners, provision of infrastructure, utilities, access to markets, safety nets, and so on. Jurisdictions that fail to provide these goods find that factors move to other jurisdictions.

Third, under a hard budget constraint (F4), local governments can go bankrupt. This provides subnational governments with the incentives for proper fiscal management. Local enterprises, politicians, and citizens hardly want their government to spend more money than is prudent. Bankruptcy would greatly hinder the ability of local governments to finance necessary public goods, such as those needed to attract foreign capital and lower business costs.

The set of conditions goes beyond market-preserving federalism to form a comparative theory of federalism. The economic and political performance of federal systems vary systematically when one or more of the conditions fail to hold.

Consider a federal system that satisfies all conditions but the common market axiom (F3). The absence of a common market allows lower jurisdictions to erect trade barriers. This implies that some areas, particularly those whose economies are not likely to perform well under open

competition, are likely to erect trade barriers to firms and products from other areas. A federalism of this sort (one which is only incompletely market-preserving) will produce seemingly contradictory results. Some areas will be observed to promote markets while others will closely control their economy, especially to prevent influence from outside the jurisdiction. The absence of a common market also implies far less pressure against political corruption. Corruption is likely to be higher in those jurisdictions that raise high trade barriers.

A second type of federal system satisfies all the axioms except F4. Several problems are likely to emerge in federal systems that fail condition F4, especially systems that decentralize authority over credit so that it remains at least in part at the discretion of subnational governments. The most obvious effect is inflation as each government “over-grazes the commons," causing too much growth in the money supply. China in the late 1980s and early 90s experienced modest inflation as a result while Brazil in the 1990s experienced hyperinflation. Decentralized access to credit softens the hard budget constraint. Governments can finance massive rent-seeking, unremonerative public works projects, or corruption and then borrow more to cover their deficits. Decentralized access to credit also allows lower jurisdictions to bail out ailing enterprises, compromising economic incentives imposed by market discipline. The absence of condition F4 thus diminishes a federal system’s political incentives for fiscal prudence and to limit political rent-seeking and corruption.

A final type of federalism fails condition F5; for example, a system in which the federal government can compromise subnational government autonomy, perhaps by declaring an emergency and legally taking over the state. This power compromises the value of political decentralization since it allows the federal government to threaten states that seek to deviate from federally desired policies.

3. Explaining differential economic performance

The payoff from the approach is that it differentiates the economic performance of various federal systems. My approach shows that whether a nation calls itself federal – "de jure federalism" – is irrelevant.[2] What matters for federal performance is the combination of conditions that hold.

The following table summarizes the effects of the conditions on federal performance. Federal states that have met all or nearly all five conditions — that is, those characterized by market-preserving federalism — have experienced sustained long-term growth. Federal states failing to meet these conditions have experienced meager or no growth. Throughout its history, the United States has been a market-preserving federal system. Except for a brief period under the Articles of Confederation, the common market condition, F3, has always held, as had the hard budget constraints for lower governments, F4 (the national government does not bailout states). Until the 1960s, states retained the lion's share of authority over economic regulation. As I argue elsewhere, the conditions have made a significant contribution to this country's economic prosperity and growth (Weingast 1995).

Table: Types of Federalism and Economic Performance.		

[2] On this issues, see Williamson (1996).

	Sustained Growth	Meager or Inconsistent Growth
Market-Preserving Federalism	Dutch Republic, 16-17 c Great Britain during the industrial revolution US, 1787 - present Modern China	
Other Federal Systems		Modern Russia Post-WWII: Argentina Brazil India Mexico

Similarly, England during the 18th century and thus the industrial revolution had a market-preserving federal structure, though not a de jure one. Constitutional changes following the Glorious Revolution of 1689 limited the national government's role in the economy and improved local government autonomy. This proved especially important during the industrial revolution, which took place not in the established commercial centers but in more remote northern England (Weingast 1995).

Many de jure federal systems differ considerably from market-preserving federalism. For example, in Argentina, Brazil, and Mexico, conditions F2 and F5 fail, and often F4. In most Latin American federalism's, the lion's share of state revenue comes from the national government. This creates several problems. First, it breaks the link between local economic prosperity and fiscal health. Second and perhaps more importantly, along with that much revenue comes restrictions, rules, and regulations of the center. Argentina in the 1980s and Brazil in the 1990s both experienced hyper-inflation due in part to profligate behavior of the lower governments, which forced the federal government to bail them out. The anticipation of such bailouts creates a soft budget constraint (i.e.,

F4 fails), leading states to spend well beyond their means. Until recently in Mexico, the dominant party, PRI, used its political power, to limit lower government autonomy. The President, as head of the PRI, used his authority to fire governors, thus limiting their ability to act independently (compromising F5). These Latin American federal systems all compromise lower government autonomy so that these governments have neither the incentive nor the ability to differentiate themselves from their neighbors. More broadly, the failure of F2 and F5 implies that the political discretion and authority retained by the central government greatly compromise their market-preserving qualities.

The de jure federalism of the former Soviet Union provides another contrast between market-preserving federalism and other forms of decentralization.[3] In that system all conditions but F1 failed. The Soviet Union was characterized by the nearly complete absence of subnational government policy discretion. Lower governments were administrative units of the central government having little power over their local economies. The center also carefully controlled factor mobility. As a consequence, federalism provided no positive incentives toward economic growth. The absence of

[3] In contrast, 18th century England was characterized by market-preserving federalism, although the English did not call their system federal (Weingast, 1995).

a hard budget constraint (F4) allowed the state to bailout ailing state owned enterprises, removing all incentives from these firms to produce efficiently.

Next, consider modern China. Although it does not call itself federal, China has extensively decentralized political decision-making, particularly over lower government budgets and over the economy. China now satisfies all the conditions except F3, though there was a modest problem with soft-budget constraints leading to modest inflation in the 1980s. The failure of F3 implies that many interior provinces have created trade barriers and "dukedom economies." Because many of the coastal provinces seek to earn rents on the competitive international market, the lack of a domestic common market hardly compromises their incentives to foster economic growth. These provinces' political autonomy over economic regulation has allowed them to provide a remarkably hospitable environment for markets and hence sustained economic growth (Montinola, Qian, and Weingast 1995). Indeed, Guangdong's famous "one step ahead" allowed it to use its new political discretion over the economy to attract an unprecedented level of investment and economic growth.

4. Federalism and Economic Reform: The emergence of PAN in Northern Mexico[4]

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[4]This section draws on my on-going research in Careaga and Weingast (2000).

In this section, we investigate recent changes in Mexican federalism, particularly the emergence of PAN in Northern Mexico. PAN arose in northern Mexico in part from the growth business class, particular small and medium size enterprises (Ward 1995). They had no big political organization, no large set of politicians with political careers who needed to live off the government system. Indeed, initial panista administrations drew many of their new officials from the business community who wanted to improve public services. We also note that northern Mexico contains one of the most vibrant parts of the economy, increasingly integrated into the United States, and hence where the economic value of public goods and services complementing market development is the highest. Put another way, economic opportunity costs under the PRI-dominated system were highest here, ...

Initially, as the PAN first started to win control of a few municipalities in Northern Mexico, PRI officials threatened to cut off funds. PRI officials had often followed a rule of rewarding their friends and punishing their enemies (Bailey 1995,176). As it turned out, PRI officials did not cut off revenue transferred by formula (*participacion*), though many funds were significantly delayed in their delivery (e.g., before elections); and many fewer funds were given from the huge federal discretionary budget (Rodriguez 1995).

A principal PAN goal was to end corruption and focus on the delivery of public goods and services that helped foster their constituent's interests. These goals included a range of municipal services, such as garbage collection, police, and water. They also favored improving accountability, citizen input, and observing the law. "One of the PAN's most successful contemporary slogans, "honestidad y eficiencia," was coined at this time" (Bailey 1995,145)

So how did the PAN survive when municipalities depend on the state and federal government for so much of their funds?

The rise of PAN represented far more than merely an attempt by a new group to capture political rents away from PRI but use them in the same way for their own politicians and officials. Instead, PAN officials sought power to implement very different policies. As it turned out, the high value of having the freedom to pursue integration with the United States plus the removing the direct political costs of the old PRI system helped them get around the PRI's fiscal punishment.

The PAN experience in the municipalities of Chihuahua and Ciudad Juarez with the police services and garbage collection provides a good examples (Ward 1995). The PRI built the old system to suit their own goals. This involved considerable corruption, including large number of so-called *aviadores* (people who simply 'fly in' to pick up their paycheck) and those nominally holding jobs having little incentives to act in accordance with agency goals. Further, many agencies employed a range of employees who worked full time on PRI business, using the agency budget to finance their operations. By firing all these "employees," PAN officials were able to hire and maintain workers dedicated to the agencies operation.

In many cases, the elimination of corruption at once lowered costs and improved service. Bailey (1995) explains how this worked for the police force. PAN officials fired old employees and hired new ones. They also built a training academy. By cleaning up corruption and focusing on the agency's goals, PAN officials were simultaneously able to greatly improve service while lowering costs. Ward (1995, 146) reports a similar story in Chihuahua for garbage collection. By eliminating corruption and making their labor force more efficient, PAN officials were able to increase collection routes to cover 95% instead of 60% of the population, while reducing total labor by 27%.

More important for the isue of PAN survival in the face of the PRI's financial threats is a point made by public finance theorists. These economists show that citizens' willingness to pay taxes

varies with the delivery of valued goods and services. Raising the value to citizens of public goods and services raises their willingness to pay taxes. Hence the PAN strategy of providing real services also secured citizens' willingness to pay new forms of taxes associated with the delivery of real services.

Hence, in several panista run cities, officials were able to shift markedly their sources of revenue. Rodriguez reports of Ciudad Juarez, for example, that "Over the course of only a few years, the ratio of state to local revenues .. changed from around 70 percent *state* funding to over 70 percent *local* funding (ingresos propios)." [166] Most of the increase in Ciudad Juarez reflected an increase in municipal funds. State contributions over the 1980s were constant in real terms while revenue from local sources increased by almost sixfold. In particular, during the first year of the panista government, 1984, local revenue increased 300%.

As Careaga and Weingast (2000) suggest, as the panista governments capture control of municipal administration, they are able to provide a range of market enhancing public goods that both serve their constituencies but also help provide more tax revenue. Local sources of revenue have grown tremendously.

5. Sequential Federalism in Mexico, China, and India.

We consider three countries in the developing world, China, India, and Mexico, where the strategy of sequential federalism has been central to the initiation of economic liberalization. In China, economic liberalization and international trade began with Guangdong Province. In India, liberalizing

states include Andhra Pradesh, Gujarat, Maharashtra, and Tamil Nadu. In Mexico, the northern tier of states, particularly Baja California North, Chihuahua, and Nuevo Leone, are increasingly becoming integrated into the United States economy. These regions are distinguished in that, of all states or provinces in their countries, they face the highest economic opportunity costs of remaining under the old system.

In each country, the relevant region has been granted or has wrestled a degree of political freedom from the center to create the political underpinnings of marketization. Decentralization focused on a small number of SNGs allowed them to adjust their political institutions, taxation system, and public goods package to foster markets and to develop or advance an export economy. China is much further along in this process than India and Mexico.

A set of conditions must hold for this type of federalism to succeed: the SNGs must be granted control over public goods and regulation relating to their economy; and they must possess a sufficient degree of fiscal autonomy, including a hard budget constraint.[5]

Following Parikh and Weingast's (1997) discussion of India, we suggest that economic and political reform in Mexico is likely to follow a two step process. In the first step, a few areas have been granted the political freedom to initiate reform "one-step ahead" — to use the Chinese phrase referring to the central government's granting to Guangdong province the political freedom to reform. Guangdong used its political and economic freedom to foster local markets and an export economy, becoming rich quite quickly (see, e.g., Oi, 1999, Shirk 19**, and Montinola, Qian, and Weingast 1995). In particular, Guangdong developed the political foundations for fostering economic

[5]These conditions correspond to meeting conditions F2-F5 of market-preserving federalism (see Weingast 1995, 2000).

reform, including fiscal independence that gave it the resources to foster public and private investment.

In the second step, other SNGs are likely to imitate the success of those jurisdictions moving one step ahead. In particular, groups of constituents and government officials in other jurisdictions begin to seek the benefits of reform. Cao, Qian and Weingast (1997) and Montinola, Qian and Weingast (1995) detail this process in China. When Guangdong freed prices in the late 1980s, other provinces remained committed to the old system of price regulation and subsidization. In relatively short order, however, prices in Guangdong had fallen for a long list of subsidized items. Other localities, including those seemingly deeply committed to the traditional communist system, began to explore marketization as a means of lowering their budgetary commitments. In Hielongjaing province, for example, the communist finance minister initiated that province's imitation of Guangdong's price liberalization as a way of reducing costly subsidies (Montinola, Qian and Weingast 1995). Similarly, once Guangdong had demonstrated that it could create immensely profitable enterprises and draw substantial sums of DFI, provinces all along the southeastern coast began to imitate and compete for these investments.

In this connection, we note the manner in which reform has emerged in a small number of industrial and export oriented states. As in Mexico, India was once dominated by a near hegemonic Congress Party. The opposition BJP party recently won national elections and formed a government. From our perspective, we draw two observations about economic liberalization in India. First, the BJP is no less corrupt or appetitious for rents and market control than their Congress predecessors. Second, their relatively weak electoral position has caused them to grant some political freedom to several states with pivotal electorates. This allowed a small group of states, such as Andhra Pradesh,

Gujarat, Maharashtra, and Tamil Nadu, to pursue economic reform. Liberalization in these states also involves a series of reforms including the provision of local public goods. The striking rise in DFI in India is concentrated in just a few states (Saez 1999). Saez (1998, table 3) reports that DFI in India increased by a factor of twenty during the early 1990s. New projects approved in FY 1995-96 were a remarkable $11 billion, though much of that figure represents promises for investment whose planning began in this year.

In China, India, and Mexico, the surplus to be earned on international markets helped motivate the local ruling coalition in the relevant states. Looking ahead, as these states attempt to capture their share of this surplus, they create the demonstration policies and programs that can be imitated by other localities.

This sketch of economic liberalization in three developing or transition states shows how the strategy of sequential federalism helps foster liberalization. In each case, the central government is not the source of reform initiatives that create an attractive business climate. To varying degrees in our three cases, the center remains locked into historic patterns of politics and policy.

These countries did not embarked on reform by initiating a national agenda with centralized control over policymaking and reform. This approach risks reform becoming lost to the usual political compromises, as interests advantaged under the old system fight to retain their subsidies, privileges, and benefits. For this reason, centralized attempts at liberalization have failed more often than not around the world. Instead, the three countries we consider here have pursued (or allowed) liberalization to take place in a particular set of localities for which the value of liberalization is the highest among all localities within the country. The central government does not choose the localities given this freedom randomly, but grants this authority to those with the highest opportunity cost

under the current system. These localities have the strongest incentive to reform their political environment so as to match the provision of policies and public goods with constituency demands for launching marketization. Moreover, competition is essential to this process. Not only must these local political units compete with one another, to survive they must compete successfully on a vibrant international market. These two competitive imperatives force localities seeking to liberalize to optimize their provision of public service to match local economic needs. Using their political freedom to create local monopolies and extract rents for a new set of constituents dooms these localities to failure in the international system.

The clearest and most advanced of this process is China. In this country, the reform process is over two decades in progress, the demonstration provinces have on the order of fifteen years experience with reform and in the process have gotten so rich relative to the status quo ante that large numbers of other provinces have followed their lead. China is now a vibrant participant in the world economy and is the target of the largest DFI anywhere in the world outside the United States.

Liberalization is less well along in Mexico and India. Our prediction for these two countries is that, as long as the federal government continues to allow a small group of states to pursue economic liberalization, a subset of these states and localities will succeed, thus serving as demonstration cases to others states and localities. This is likely to be followed by increased demands from other states and localities for freedom to imitate those who have already succeeded. This process may well undermine the type of political regimes that have ruled in each of these countries. Indeed, this process seems to be happening in Mexico as the PRI has lost its hegemonic status.

6. Conclusions

These notes sketche a comparative theory of federal performance. I propose four conditions that differentiate among federal systems. The conditions relate to the various ways in which federal systems allocate political and economic power among levels of government. The theory demonstrates that different allocations of power yield different patterns of economic performance. A specific subset of systems satisfying all four conditions, called market-preserving federalism, have experienced sustained economic growth. Other types of federal systems satisfy fewer or none of the conditions and typically have much poorer economic performance.

Market-preserving federalism holds the potential for fostering markets, in part because it limits the interventionist tendencies that plague all levels of governments in developing countries. This ideal type of federalism satisfies four conditions: it limits the authority of the national government over the economy; it fosters competition among lower governments in part through the common market; it limits the ability of the national government to bail out fiscally imprudent behavior; and it limits the ability of the national government to compromise lower government autonomy. Federal systems that fail to satisfy one or more of these conditions only incompletely foster markets, if they do so at all.

The discussion in section 3 shows that this framework helps explain why federal systems exhibit such divergent economic performance. Federal states characterized by market-preserving federalism experience sustained growth, including the United States, Modern China, the Dutch Republic in the seventeenth century, and England during the eighteenth century. Federal states not

characterized by market-preserving federalism fail to exhibit sustained growth, including modern Russia, the former Soviet Union, India, and the large federal states in Latin America, such as Argentina, Brazil, and Mexico.

Sections 4 and 5 compared the experience in Mexico, China and India. I argue that in each case federalism has provided the political frontier of economic reform. In each, the implementation of liberalization was not launched by the national government — although it provided (or acquiesced in allowing) the authority to lower levels to do so. Reform instead began within a small number of provinces or states. These states were not randomly selected, but represented those states/ provinces with the highest economic opportunity costs of remaining under the old system. Constituents, firms, and political officials in these states/ provinces sought to be free of the old system, in part to pursue economic goals not feasible under the status quo. Each state/ provincial government had strong incentives to engineer reform: not only did this provide direct benefits to their constituents, but successful reform represented the road to real fiscal independence of the central government.

This process is furthest along in China, where nearly every province has begun elements of reform. As Montinola, Qian, and Weingast (1995) and others detail, the process of reform followed that typical of innovation in federal systems. Experiments were run locally, and then other jurisdictions imitate the successful ones.

Of course, this approach only covers certain aspects of federalism, particularly the relationship between political authority and economic performance. This focus omits a range of important aspects of federal performance, such as ethnic or regional harmony; and the mechanisms providing for political stability, notably the party system.

Let me conclude by making an important observation about this approach to federalism: it makes no mention of democracy. Perhaps democracy — particularly certain types of competition among parties — provides a major mechanism that helps sustain federalism (see Riker 1964). This is not a condition for federalism, however, but for federal stability. Further, most discussions of this point at best argue that certain forms of party competition are a sufficient condition for federal stability, not a necessary condition. Our discussion of federalism in China (Montinola, Qian, and Weingast 1995) suggest that stable federalism can occur without democracy. Nonetheless, a major open question concerns the mechanisms by which federalism becomes self-enforcing.

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