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DOES FEDERALISM PRESERVE MARKETS?

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POVERTY, poor health, low life expectancy, and an unequal distribution of income and wealth are endemic throughout the world. Many countries, including some that are well-endowed with natural resources, have very low or negative growth rates and low per capita incomes.¹ Indeed, poor countries and those with poor growth records are often in difficulty precisely because they are unable to use their human and material resources effectively. The reasons for this failure are as multitudinous as the history and culture of the individual countries involved, but there are some common threads. Evidence suggests that economic growth is hampered and foreign aid undermined in countries with poorly functioning public institutions.² Thus economists and political scientists have begun to focus on the link between political institutions and economic performance.³ In the forefront of this movement are scholars of the new institutional economics (“NIE”). They emphasize the importance of secure, predictable political foundations for markets—an appropriate governance structure.⁴

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¹ Human Development Report 1997, U.N. Development Programme at 146-48, 161-63 (1997).

² See Craig Burnside & David Dollar, *Aid, Policies, and Growth* (World Bank Policy Research Div. Working Paper No. 1777, 1997); Stephen Knack & Philip Keefer, *Institutions and Economic Performance: Cross-Country Tests Using Alternative Institutional Measures*, 7 *Econ. & Pol.* 207 (1995); Mancur Olson, Jr., *Distinguished Lecture on Economics in Government: Big Bills Left on the Sidewalk: Why Some Nations are Rich, and Others Poor*, *J. Econ. Persp.*, Spring 1996, at 3 (1996).

³ See, e.g., Knack & Keefer, *supra* note 2; Olson, *supra* note 2.

⁴ See Oliver E. Williamson, *The Mechanisms of Governance* 325-43, 378 (1996).

The success of advanced market systems is, in part, a function of institutional structures that reduce the uncertainty of market interaction and encourage investment—including clearly defined and enforced property rights, a reliable law of contracts, and rules of third party enforcement.⁵ NIE scholars note that less developed countries have often found it difficult to create or sustain these structures.⁶

Recent contributions to the NIE literature on development stress the importance of well-functioning government institutions. Barry Weingast describes the “fundamental political dilemma of an economic system”:⁷

[A] government strong enough to protect property rights is also strong enough to confiscate the wealth of its citizens. Thriving markets require not only the appropriate property rights system, an unfettered price mechanism, and a law of contracts, but a secure political foundation that limits the ability [of] the state to confiscate wealth by altering those rights and systems.⁸

The prospect of political interference with markets deters investment and other economic activity. Therefore, to promote markets and growth, political institutions should credibly commit the state to preserving markets.⁹ The state must be powerful yet limited: On the one hand, it must be strong enough to assure economic actors that it can enforce contracts and property rights; on the other hand, it must convince them that it will not make confiscatory demands.¹⁰

⁵ See Douglass C. North, *Institutions, Institutional Change and Economic Performance* 107-17 (1990); Douglass C. North, *Structure and Change in Economic History* 201-09 (1981).

⁶ See Olson, *supra* note 2, at 19-23.

⁷ Barry R. Weingast, *Constitutions as Governance Structures: The Political Foundations of Secure Markets*, 149 *J. Institutional & Theoretical Econ.* 286, 287 (1993).

⁸ *Id.* (citation omitted).

⁹ See Douglass C. North, *Institutions and Credible Commitment*, 149 *J. Institutional & Theoretical Econ.* 11, 13-14, 19-21 (1993) (discussing “credible commitment” and its importance in economic history).

¹⁰ Pranab Bardhan quotes the French poet Paul Valery: “If the state is strong it will crush us; if it is weak, we will perish.” Pranab Bardhan, *The Nature of Institutional Impediments to Economic Development* 11 n.6 (Ctr. for Int’l & Dev. Econ. Research Working Paper No. C96-066, 1996).

Barry Weingast and his collaborators, Gabriella Montinola and Yingyi Qian, assert that “market-preserving federalism”¹¹ (“MPF”), a concept derived from public choice models of competitive federalism, allows politicians to make this unique, credible commitment to preserving the market.¹² They argue that decentralized control over the economy by subnational governments within a common market prevents the central government from interfering with markets.¹³ Intergovernmental competition over mobile sources of revenue also constrains individual subnational governments.¹⁴ Weingast and his collaborators explain that under certain conditions, a market-preserving federal balance can be self-enforcing.¹⁵ That is, governmental officials face incentives to abide by the limits imposed on them. Weingast uses this model to explain investment, entrepreneurial activity, and high growth rates in eighteenth-century England, the United States in the nineteenth and early twentieth centuries, and contemporary China.¹⁶

This Article examines the positive and normative implications of market-preserving federalism. In Part I, we summarize Weingast’s model and sort out some of its positive and normative claims. We argue that the model lacks important institutional features that, if included, would affect its predictions. We have no quarrel with the logic of the model as it stands. Rather, our critique highlights the lack of a strong theory explaining how these conditions might arise in real political systems. Weingast’s work is insufficiently grounded in a theory of politics.

In Part II, we ask whether MPF can in fact solve the “fundamental political dilemma of an economic system,”¹⁷ and question whether state-level politicians really have no alternative but to maximize state income and wealth. We argue that, under a range of plausible conditions, federal systems will not bear out Wein-

¹¹ Barry R. Weingast, *The Economic Role of Political Institutions: Market-Preserving Federalism and Economic Development*, 11 *J.L. Econ. & Org.* 1, 3 (1995).

¹² Gabriella Montinola, Yingyi Qian & Barry R. Weingast, *Federalism, Chinese Style: The Political Basis for Economic Success in China*, 48 *World Pol.* 50, 53 (1995); Weingast, *supra* note 7, at 288.

¹³ Montinola, Qian & Weingast, *supra* note 12, at 58.

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ Weingast, *supra* note 11.

¹⁷ Weingast, *supra* note 7, at 287.

gast's predictions. When they do not, a move to greater decentralization may reduce rather than increase efficiency.

Part III asks whether an MPF is sustainable as a political equilibrium under which a federal government credibly limits itself to providing public goods like a common market, contract enforcement, and a stable currency. We also examine political responses to some costs of decentralization and argue that the strong but limited central government required by MPF may be very difficult to maintain.

Part IV addresses normative concerns. Calls for radical decentralization and deregulation in the name of efficiency are sometimes made by developmental economists, and the MPF model would seem to bolster their arguments.¹⁸ Weingast implies that *de jure* federations like Argentina, Brazil, and India would experience Chinese-style economic performance if they were to decentralize their federal systems along MPF lines.¹⁹ By contrast, we question the value of MPF as a guide to institutional reform in the developing world and suggest that it may exaggerate rather than ameliorate some important institutional impediments to development. We do not claim that a completely centralized system ought to be the norm. Obviously, in an imperfect, highly politicized world, federalism can provide valuable checks on those with political power. Rather, we isolate situations where marginal moves to increase decentralization will harm a nation's prospects for growth.

While we make references to several examples throughout this Article, we pay special attention to the case of India. India has been a *de jure* federal system since independence, but does not currently meet Weingast's requirements for market-preserving federalism because "the political authority of the national government compromises the independence of local political authority."²⁰

¹⁸ For a balanced assessment of these arguments, see Vito Tanzi, *Fiscal Federalism and Decentralization: A Review of Some Efficiency and Macroeconomic Aspects*, in *Annual World Bank Conference on Development Economics 1995*, at 295 (Michael Bruno & Boris Pleskovic eds., 1996).

¹⁹ Weingast, *supra* note 11, at 28.

²⁰ *Id.*

As Weingast implies,²¹ India's de jure federal structure seems to make it a good candidate for reforms aimed at establishing the conditions for market-preserving federalism. In fact, recent reforms seem to be pushing India closer to Weingast's criteria.²² In examining the Indian case, we question whether a more decentralized Indian federation will follow Weingast's model toward a new commitment to markets and sustained investment and growth.

I. MARKET-PRESERVING FEDERALISM

Market-preserving federalism seeks to provide an institutional framework to mitigate the fundamental dilemma posed by Weingast: that in order for markets to thrive, the state must be strong yet limited. Weingast argues that the fundamental feature of federalism is credible decentralization, and his theory of federalism is more concerned with de facto decentralization of political power than with de jure institutional distinctions.²³ Thus Weingast presents eighteenth-century England and contemporary China as examples of MPF, although they are not usually categorized as federal states.²⁴

The market-preserving federalism concept adds to and modifies earlier conceptions of federalism by adding several conditions. William Riker defines federalism as a hierarchy of governments in which: 1) "two levels of government rule the same land and people"; 2) each has a well-defined scope of authority; and

²¹ Id. See also Montinola, Qian & Weingast, *supra* note 12, at 57 (detailing which conditions for MPF are lacking in India).

²² A key goal of recent economic reforms was the encouragement of investment competition among the states. See Narayanan Madhavan, *India's New Government To Give States More Powers*, Reuters World Service, June 5, 1996, *available in* LEXIS, News Library, Reuwl File. The Tenth Finance Commission recommended a major devolution of fiscal authority to the states, and the recently formed coalition government is composed of state-based regional parties whose agenda consists largely of implementing the recommendations of the Finance Commission and initiating other devolutionary measures. See *id.*; Jeremy Clift, *India Urges Reform by State-Level Governments*, Reuter Asia-Pac. Bus. Rep., Mar. 14, 1995, *available in* LEXIS, News Library, Reuapb File; see also Mark Nicholson, *The Dawning of a New Era*, *Fin. Times*, May 13, 1996, *available in* LEXIS, News Library, Fintme File (discussing rise of India's regional parties).

²³ Montinola, Qian & Weingast, *supra* note 12, at 57.

²⁴ Weingast, *supra* note 11.

3) each possesses a guarantee of autonomy within its own sphere of authority.²⁵ Weingast and his collaborators add four additional requirements for market-preserving federalism that deal specifically with the role of the state in the economy:

[4] The subnational governments have primary authority over the economy within their jurisdictions.

[5] The national government has the authority to police the common market and to ensure the mobility of goods and factors across subgovernment jurisdictions.

[6] Revenue sharing among governments is limited and borrowing by governments is constrained so that all governments face hard budget constraints.

[7] The allocation of authority and responsibility has an institutionalized degree of durability so that it cannot be altered by the national government either unilaterally or under the pressures from subnational governments.²⁶

Weingast argues that these additional requirements give federalism its market-preserving quality and mitigate the fundamental dilemma by building a state that is limited but capable. Under these conditions, he maintains, the state is limited, and commitments not to confiscate are credible: 1) no level of political authority has a monopoly on regulatory power; 2) the federal government has sharply restricted regulatory powers; and 3) the sub-units are constrained from engaging in inefficient, confiscatory regulation by the fact that they must compete with one another over mobile sources of revenue.²⁷ The central government, however, still plays an important role in MPF because it must provide national public goods with interjurisdictional spillovers that would be underprovided if left only to the sub-units.²⁸ It also must police the common market (requirement five) and oversee monetary policy.²⁹

²⁵ William H. Riker, *Federalism: Origin, Operation, Significance* 11 (1964). See also Daniel J. Elazar, *Exploring Federalism* (1987) (discussing the traditional conception of federalism); Preston King, *Federalism and Federation* (1982) (same).

²⁶ Montinola, Qian & Weingast, *supra* note 12, at 55 (italics omitted).

²⁷ *Id.* at 58.

²⁸ *Id.* at 55. See also Wallace E. Oates, *Fiscal Federalism* 31-53 (1972) (offering the theory of the optimal division of functions among levels of government in decentralized systems).

²⁹ Montinola, Qian & Weingast, *supra* note 12, at 55.

This model is an ideal type.³⁰ We do not question its logic. Our critique, instead, focuses on the difficulty of achieving the model's conditions in practice. This Article demonstrates that when some of the conditions are violated, the result is not merely to reduce the sharpness of the conclusions, but to reverse them.

To begin, the Riker/Weingast conditions are unlikely to be met simultaneously. Even Riker's original definition of federalism can only be imperfectly approximated. His framework implies that the pre-1930s American notion of dual federalism is still possible and desirable.³¹ An MPF would have to resemble a layer cake, with each distinct layer of government linked only by frosting, rather than a marble cake, in which the layers are swirled together.³² Jurisdictional lines separating levels of government in modern federal systems are rarely so well-defined, and it is usually a mistake to view any jurisdictional unit as autonomous. It is almost impossible for a federal constitution to assign precisely all of the tasks of government to specific jurisdictional units. Moreover, constitutions are notoriously poor guides to the actual distribution of governmental authority, which in modern federations is normally a fluid, highly contingent outcome of intergovernmental conflict and cooperation.³³ Representatives of jurisdic-

³⁰ Weingast and his collaborators recognize this. *Id.*

³¹ For historical background on American dual federalism in the 1930s, see Edward S. Corwin, *The Twilight of the Supreme Court: A History of Our Constitutional Theory* 1-15 (1934); see also Edward S. Corwin, *The Commerce Power Versus States Rights* 253-69 (1936) (discussing dual federalism in the context of the Commerce Clause).

³² See Morton Grodzins, *The American System: A New View of Government in the United States* 7-8 (Daniel J. Elazar ed., 1966) (invoking the marble cake metaphor to describe American federalism).

³³ If federal constitutions and founding documents are contracts, they are inherently incomplete. See Avinash K. Dixit, *The Making of Economic Policy: A Transaction-Cost Politics Perspective* 20 (1996). Constitutional contracts are often incomplete for the same reasons that business contracts are often incomplete: "(1) the inability to foresee all the possible contingencies, (2) the complexity of specifying rules, even for the numerous contingencies that can be foreseen, and (3) the difficulty of objectively observing and verifying contingencies so that the specified procedures may be put into action." *Id.* See also Oliver E. Williamson, *The Economic Institutions of Capitalism* 178 (1987) (discussing incomplete business contracts). A good example of the incomplete nature of federal founding documents is the allocation of jurisdictional authority to provide worker training in Canada. See generally J. Stefan Dupré et al., *Federalism and Policy Development: The Case of Adult Occupational Training in Ontario* (1973) (analyzing the termination in 1966 of the conditional grant relationship between

tional units often interact in various complex networks characterized by bargaining, reciprocity, and log-rolling, and their autonomy may be limited by strong party ties.³⁴ Federal systems rarely outlaw such links and, in fact, the realities of federal regimes may encourage their formation.³⁵

Weingast's additional requirements are also difficult to achieve. It is rare for subnational governments to satisfy the fourth requirement by having *primary* authority over economic regulation.

the provinces and the Canadian government with respect to vocational training); Rodney Haddow, *Federalism and Training Policy in Canada: Institutional Barriers to Economic Adjustment*, in *New Trends in Canadian Federalism* 338 (François Rocher & Miriam Smith eds., 1995) (examining federal-provincial relations surrounding the main worker training initiatives of Prime Minister Brian Mulroney). Worker training was not one of the enumerated powers of the British North America Act, 1867, 30 Vict., ch. 3 (Eng.). Provinces have, however, viewed training as falling under their exclusive right to "make Laws in relation to Education." *Id.* § 93. In the post-war era, however, the Canadian federal government has been increasingly active in this area, justifying its activities with reference to its general authority over the economy and its federal spending powers. Haddow, *supra*, at 339. Like many policy areas in Canada, training policy has been shaped by intermittent battles and cooperative deals between Ottawa and the provinces. Policies in this area are presently made by a complex and delicate intergovernmental bargaining process. *Id.* at 339-40.

³⁴ On the complexity of modern governmental relations, see Ralph J.K. Chapman, *Structure, Process and the Federal Factor: Complexity and Entanglement in Federations*, in *Comparative Federalism and Federation* 69, 69-77 (Michael Burgess & Alain-G. Gagnon eds., 1993). As with Canada, see *supra* note 33, many policy decisions in the German federal system are reached through complex intergovernmental bargaining involving politicians and bureaucrats representing the federal government (the Bund) and the states (the Länder). While state-level governments play an important role in formulating and implementing national policy, they are not autonomous in Riker's sense. See Fritz W. Scharpf, *Theorie der Politikverflechtung*, in *Politikverflechtung: Theorie und Empirie des kooperativen Föderalismus in der Bundesrepublik* 13 (Fritz W. Scharpf, Bernd Reissert & Fritz Schnabel eds., 1976) (describing "interlocking" federalism in Germany). The two main political parties in Germany, the Christian Democratic Union (C.D.U.) and the Social Democratic Party of Germany (S.P.D.), are characterized by high levels of coordination between levels of government, and in most bargaining situations the representatives of the Länder are likely to take positions determined by political party leaders, often at the national level. Gerhard Lehmbuch, *Institutional Linkages and Policy Networks in the Federal System of West Germany*, *Publius*, Fall 1989, at 221, 232-35. See also Heidrun Abromeit, *Die Funktion des Bundesrates und der Streit um seine Politisierung*, 13 *Zeitschrift für Parlamentsfragen* 462, 467-71 (1982) (discussing the growing importance of national political parties in formulating and representing the interests of the Länder in the German federal system).

³⁵ See William M. Chandler, *Federalism and Political Parties*, in *Federalism and the Role of the State* 149, 152-55 (Herman Bakvis & William M. Chandler eds., 1987).

For reasons discussed below,³⁶ national and subnational political leaders as well as interest groups with redistributive agendas have incentives to centralize certain kinds of economic regulation. Furthermore, if the central government is incapable of substantive economic regulation, it is probably not capable of policing the common market and providing other national public goods, thus failing to meet the fifth requirement. Indeed, Weingast's treatment of the Chinese case suggests that there may be a trade-off between credible decentralization and the ability to provide national public goods.³⁷ In addition, intergovernmental borrowing and revenue-sharing are facts of life in most intergovernmental systems, and the hard budget constraints of requirement six are difficult to achieve, especially if party ties provide incentives for bailouts.

The last requirement is perhaps the most important and difficult to achieve: It stipulates that institutional or social circumstances exist that maintain the market-preserving quality of the federation. It is met in different ways in each of Weingast's cases. In England, durable local political freedoms emerged as part of the constitutional consensus embodied in the Revolution Settlement of 1689.³⁸ "[N]ational interference with local power during the [Stuart] campaign to pack the constituencies [and disenfranchise the Whigs] produced a consensus that protection of local power against national interference was essential to the maintenance of individual liberty and security."³⁹ In the United States in the nineteenth century, the division over slavery created two groups that were mutually suspicious that the other might dominate national policymaking; this created durable limits on national authority.⁴⁰ In China, although the initial decentralization by decree had no durability, the interests of local leaders eventually became aligned with local economic success, and their stake in continued decentralization makes retrenchment increasingly unlikely as key provinces continue to prosper.⁴¹ In sum, rather

³⁶ See *infra* Part II.

³⁷ See Montinola, Qian & Weingast, *supra* note 12, at 59-60.

³⁸ Weingast, *supra* note 11, at 15-18.

³⁹ *Id.* at 18.

⁴⁰ *Id.* at 18-21.

⁴¹ *Id.* at 21-24.

than providing a general model for meeting this last requirement, Weingast presents three very different and context-dependent stories. Yet this last requirement is centrally important. If it is not met in some way, market-preserving federalism fails. The durability and credibility of decentralization, and hence the ability of federalism to protect markets and facilitate growth, thus depends on factors outside of the MPF model. By leaving the institutional mechanism required to produce durability unspecified, Weingast leaves many important questions unexplored.

Weingast's model does not present the institutional microfoundations needed for credible decentralization. Without a stronger grounding in politics, the framework's empirical claims for the costs and benefits of a federal structure are weak. The remainder of this Article questions the value of Weingast's model as either a convincing general solution to his fundamental political dilemma or as a useful prescriptive model for the developing world.

II. DOES COMPETITIVE FEDERALISM CONSTRAIN SUBNATIONAL LEADERS?

Although the roots of the theory of competitive government go back to Friedrich Hayek,⁴² Charles Tiebout provided the framework for recent research.⁴³ Tiebout's simple model analogizes political competition to private market competition by considering competing political jurisdictions that offer different combinations of taxes and services to potential residents.⁴⁴ Tiebout's efficient, apolitical intergovernmental market analogy spawned a large normative literature on the potential advantages of interjurisdictional competition.⁴⁵ Weingast joins other recent contri-

⁴² See Friedrich A. Hayek, *The Economic Conditions of Interstate Federalism*, in *Individualism and Economic Order* 255 (1948).

⁴³ Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 *J. Pol. Econ.* 416 (1956).

⁴⁴ *Id.* at 419-20.

⁴⁵ See, e.g., Geoffrey Brennan & James M. Buchanan, *The Power to Tax: Analytical Foundations of a Fiscal Constitution* 184-86 (1980); Albert Breton & Anthony Scott, *The Design of Federations* 13-19 (1980); Thomas R. Dye, *American Federalism: Competition Among Governments* (1990); Gordon Tullock, *The New Federalist* (1994); Albert Breton, *The Existence and Stability of Interjurisdictional Competition*, in *Competition Among States and Local Governments* 37 (Daphne A. Kenyon & John Kincaid eds., 1991); James M. Buchanan, *Europe's Constitutional Opportunity*, in

butors to this literature such as James Buchanan by combining Tiebout's competitive logic with assumptions about the rent-seeking motivations of self-interested political leaders, and by considering the role of capital and labor mobility in constraining rent-extraction.⁴⁶

Weingast argues that since leaders of political units in a decentralized political system must compete for mobile sources of revenue, they are prevented from imposing debilitating regulations.⁴⁷ "The federalized structure, through the forces of interstate competition, effectively limits the power of the separate political units to extract surplus value from the citizenry."⁴⁸ Under this approach, if any state were to attempt to impose rent-seeking regulations, capital owners and workers alike would move to different jurisdictions offering more investment-friendly environments, and "only those economic restrictions that citizens are willing to pay for will survive."⁴⁹

Weingast's version of competitive federalism invites many of the same criticisms leveled against Tiebout models.⁵⁰ Although

Europe's Constitutional Future 1 (James M. Buchanan et al. eds., 1990) [hereinafter Buchanan, Opportunity]; James M. Buchanan, *Federalism As an Ideal Political Order and an Objective for Constitutional Reform*, Publius, Winter 1995, at 19 [hereinafter Buchanan, Federalism]; Wallace E. Oates & Robert M. Schwab, *The Allocative and Distributive Implications of Local Fiscal Competition*, in *Competition Among States and Local Governments*, supra, at 127.

⁴⁶ Rent-seekers expend energy, money, and time to divert the gains of economic and political activity to themselves or their supporters. They are typically contrasted with those who engage in productive, wealth-creating activities. In practice, of course, rent-seeking and productive activity are often intertwined. Nevertheless, the concept of rent-seeking is a useful way to highlight wasteful attempts to appropriate a larger share of a fixed quantity of resources. See Brennan & Buchanan, supra note 45, at 13-33; Buchanan, *Federalism*, supra note 45, at 19-23. The rent-seeking assumptions employed by Weingast and these authors differ from those made in recent contributions by Wallace Oates and Robert Schwab, in which competing governments are benevolent social welfare maximizers. See Wallace E. Oates & Robert M. Schwab, *Economic Competition among Jurisdictions: Efficiency Enhancing or Distortion Inducing?*, 35 J. Pub. Econ. 333, 335 (1988); Oates & Schwab, supra note 45, at 128-30.

⁴⁷ Weingast, supra note 7, at 290.

⁴⁸ Buchanan, *Federalism*, supra note 45, at 21.

⁴⁹ Weingast, supra note 7, at 292.

⁵⁰ For critiques of Tiebout models, see, e.g., Truman F. Bewley, *A Critique of Tiebout's Theory of Local Public Expenditures*, 49 *Econometrica* 713 (1981); Robert P. Inman & Daniel L. Rubinfeld, *The Political Economy of Federalism*, in *Perspectives on Public Choice: A Handbook* 73, 80-86 (Dennis C. Mueller ed., 1997); Susan Rose-Ackerman, *Tiebout Models and the Competitive Ideal: An Essay on the Political*

critiques have focused on a variety of issues, we stress the most important problems associated with normative theories of competitive federalism in the Tiebout tradition: They are efficiency-driven, demand-side arguments that assume away politics and institutions, especially at the regional level. A more realistic theory of federalism must endeavor to model political choices made in complex institutional environments.

Missing from the competitive federalism literature is a treatment of the institutional supply side. The pressure placed on political leaders from competition over mobile revenue sources is undeniable. Nonetheless, policy demands from citizens and interest groups only become policy outcomes through the operation of political institutions. Whether political leaders respond to highly mobile investors or less mobile distributive coalitions depends largely on the nature of institutional accountability relationships.

In a pure MPF, demand-side arguments *are* all that matters. The theory holds that the self-interested decisions of holders of mobile assets further efficiency as in a competitive market. Anyone who stands in their way is punished harshly by the discipline of the market. State and local political institutions are irrelevant, and leaders' stated goals are unimportant. It does not matter if state politicians are kleptocrats, bleeding-heart liberals, or supporters of business interests; they must select efficient policies or risk impoverishing the state as capital and labor exit. In fact, Weingast shows an affinity with so-called Leviathan theorists⁵¹ in arguing that leaders gain if investment and entrepreneurial activity, and hence government revenue, grow within their jurisdictions.⁵² He argues that when the ability to extract rents is

Economy of Local Government, *in* 1 Perspectives on Local Public Finance and Public Policy 23 (John M. Quigley ed., 1983); Joseph E. Stiglitz, The Theory of Local Public Goods, *in* The Economics of Public Services (Martin S. Feldstein & Robert Inman eds., 1977); Joseph E. Stiglitz, The Theory of Local Public Goods Twenty-Five Years After Tiebout: A Perspective, *in* Local Provision of Public Services: The Tiebout Model After Twenty-Five Years 17 (George R. Zodrow ed., 1983).

⁵¹ See, e.g., Brennan & Buchanan, *supra* note 45, at 26-33 (explaining that those who control government seek to maximize the revenue extracted from the population less the cost of public services).

⁵² Nowhere does Weingast explicitly argue that local political leaders are wealth-maximizers. In the discussions of local Justices of the Peace in England, Weingast, *supra* note 11, at 7, and local leaders in China, *id.* at 22, however, it is clear that the

tied to the prosperity of the local economy, rulers will develop something like an encompassing interest⁵³ in its continued good health and abstain from making confiscatory demands. Leaders are presumably seen as rent-seekers, but rents are directly proportional to economic prosperity. Interjurisdictional competition limits the government's ability to extract excessive rents. However, in a well-functioning MPF, the goals of politicians are of little importance because the intergovernmental marketplace constrains their behavior.

Although we agree with Weingast that state and local leaders cannot ignore the demands of mobile capital owners, we argue that he goes too far. Politicians do not necessarily optimize the resources that flow from successfully attracting and retaining mobile capital. Political accountability relationships are much more complex. In a democracy, for example, elected leaders must respond not only to exit threats, but also to electoral threats. State-level leaders respond to exit threats not only because they want to maximize the revenue at their disposal, but also because if assets flow out of their jurisdictions, their constituents will suffer economically, and the incumbents will have to pay the electoral consequences.

In addition, political leaders may face electoral incentives to ignore the threats of the mobile and make pacts with coalitions of less mobile constituents. Owners of capital vary widely in the specificity of their assets. As Albert Hirschman suggests, owners of relatively immobile assets and others whose exit threats are less credible will be left with the option of mobilizing to express their preferences.⁵⁴ The stakes for owners of specific factors in maintaining the status quo may be very high,⁵⁵ and political leaders may face institutional incentives to be accountable to strong

interests of local officials become aligned with local economic success because they aim to enrich themselves.

⁵³ We use the term in the sense used by Mancur Olson, *The Rise and Decline of Nations: Economic Growth, Stagflation, and Social Rigidities* 50-53 (1982).

⁵⁴ Albert O. Hirschman, *Exit, Voice, and Loyalty: Responses to Decline in Firms, Organizations, and States* 30-43 (1970).

⁵⁵ James E. Alt & Michael Gilligan, *The Political Economy of Trading States: Factor Specificity, Collective Action Problems and Domestic Political Institutions*, 2 *J. Pol. Phil.* 165, 188-91 (1994).

coalitions of immobile asset holders.⁵⁶ For example, it is often difficult for elected officials to ignore the demands of well-organized, immobile agricultural interests because such interests are sometimes able to dominate the political process in sub-units. This is the case in India, where party politics at the state level is often dominated by agricultural interests.⁵⁷ Further examples are provided by mining in the United States: Before the passage of federal laws, some states largely ignored the environmental damage of coal mining because of the industry's importance to their economy,⁵⁸ and Alaska has been very deferential to the interests of the oil industry.⁵⁹ Depending on the nature of institutional incentives facing political leaders, a variety of interest groups may be able to perpetuate inefficient policies despite competitive pressures.

Weingast might argue in turn that the wealth-maximizing solution will still be preferred by the politician. He or she acts to keep overall income as high as possible and then uses lump sum taxes and transfers to favor those with political influence. There are, however, several problems with this argument. First, it requires an all-powerful ruler who is free to redistribute economic benefits with little deadweight loss. Few governments fit this model, and few political leaders are so powerful. Second, in a

⁵⁶ Jerry L. Mashaw & Susan Rose-Ackerman, *Federalism and Regulation*, in *The Reagan Regulatory Strategy: An Assessment* 111, 128-32 (George C. Eads & Michael Fix eds., 1984). We do not argue that highly specific assets necessarily provide political advantages to their owners; only that the owners of such assets have relatively stronger incentives to engage in collective action. In fact, the ownership of highly specific assets is often a disadvantage. Because their exit threats are less credible, owners of specific assets run the risk that political leaders will attempt to expropriate excess value from them. See *infra* note 94 and accompanying text (discussing Enron's investment in the Dabhol power project); cf. Christopher Grandy, *Can Government Be Trusted To Keep Its Part of a Social Contract?: New Jersey and the Railroads, 1825-1888*, 5 *J.L. Econ. & Org.* 249, 266-67 (1989) (describing the dynamics leading the state of New Jersey to renege on long-term contracts with railroad companies that had made substantial investments in immobile assets).

⁵⁷ Ashutosh Varshney, *Self-Limited Empowerment: Democracy, Economic Development and Rural India*, *J. Dev. Stud.*, July 1993, at 177, 178-80.

⁵⁸ See D. Michael Harvey, *Paradise Regained? Surface Mining Control and Reclamation Act of 1977*, 15 *Hous. L. Rev.* 1147, 1148-49 (1978).

⁵⁹ See *Alaska: The Last Frontier*, *Economist*, Oct. 19, 1991, at 30, 31; William S. Brown & Clive S. Thomas, *The Alaska Permanent Fund: Good Sense or Political Expediency?*, *Challenge*, Sept. 1994, at 39.

pure MPF, economic rents cannot be captured by government leaders. Exit threats imply that mobile businesses will keep whatever rents are not competed away by the market, and governments will not be able to capture any excess economic benefit.⁶⁰ Third, even if politicians do hope to use their official positions to extract rents, their ability to do so is constrained by the need to stay in office.⁶¹ Elected local officials in democracies must win nominations and elections by pleasing important party members and constituents. They must often raise money for expensive campaigns as well. In order to stay in office, leaders must respond to the institutional incentive structures set up by party organizations, electoral rules, campaign finance laws, and a host of other structures. Similarly, local leaders in authoritarian systems must protect their positions by pleasing party, bureaucratic, and military constituencies, by building coalitions, and by staying off costly riots and unrest.

Thus, in order to model political choices made by local leaders, it is necessary to ask not only whether they maximize revenue, but more importantly, how they sustain themselves politically. Weingast and his collaborators argue that if decentralization goes far enough and the requirements for market-preserving federalism are met, local leaders, with primary control over regulation and taxation, must provide relatively efficient levels of regulation and refrain from over-taxation.⁶² This is so, however, only in a simple, uncompromising MPF model where public officials have no room to maneuver.

In more realistic cases, local officials will not choose efficient policies unless they believe that their political survival is enhanced by good performance. In such cases, Weingast's argument requires that leaders who fail to respond to exit threats by providing a good investment environment and local prosperity

⁶⁰ Susan Rose-Ackerman, *Environmental Policy and Federal Structure: A Comparison of the United States and Germany*, 47 *Vand. L. Rev.* 1587, 1591-97 (1994).

⁶¹ The assumption that elected officials are primarily interested in reelection dominates the political science literature on the American Congress. For the original formulation and defense of this assumption, see David R. Mayhew, *Congress: The Electoral Connection* (1974). For a recent literature review, see Kenneth A. Shepsle & Barry R. Weingast, *Positive Theories of Congressional Institutions*, 19 *Legis. Stud. Q.* 149 (1994).

⁶² Montinola, Qian & Weingast, *supra* note 12, at 58-59.

are quickly punished. Exit of business impoverishes the population, which then selects another leader. In much of the world, however, the political process at the local and regional level is not so simple. First, in democracies, electoral competition will not necessarily punish state or local leaders who fail to respond to the demands of the intergovernmental market. Second, sub-national leaders in authoritarian systems will not necessarily be responsive to the threats of mobile capital owners.

A. Democracies

Electoral competition will frequently fail to punish state and local leaders who do not respond to the exit threats of mobile asset holders. There are two reasons for this. First, even a majoritarian polity will not always favor efficient policies.⁶³ Second, many nominally democratic states, especially in the developing world, sustain themselves through the provision of personalized services rather than public goods.

The first situation can occur if a proposed policy would permit a minority to gain a great deal at the expense of the majority. Even if total benefits exceed total costs, such a policy would not pass in a majoritarian system. Furthermore, policies that will benefit a majority of the population *ex post* may not win majority approval *ex ante*.⁶⁴ In general, an honest democratic politician who proposes policies that will gain majority support may not favor efficient policies, even though voters would support those policies once they are firmly in place. For example,

⁶³ See Susan Rose-Ackerman, *Inefficiency and Reelection*, 33 *Kyklos* 287 (1980) (demonstrating the potential conflicts between efficient policies and those that maximize politician's reelection chances).

⁶⁴ Raquel Fernandez and Dani Rodrik demonstrate this point. See Raquel Fernandez & Dani Rodrik, *Resistance to Reform: Status Quo Bias in the Presence of Individual-Specific Uncertainty*, 81 *Am. Econ. Rev.* 1146 (1991). Their argument depends upon the condition that not all winners and losers are precisely identified *ex ante*. *Id.* at 1148-49. Suppose, for example, a policy is on balance efficient and that *ex post*, 60% of the voters will gain while 40% will lose. However, *ex ante*, at the time of the vote, 40% are certain to gain, while the remaining 60% are unsure how things will turn out. Under plausible assumptions about the level of gains and losses, the policy will be voted down, 60% to 40%. Of course, one can construct reverse cases where an inefficient policy is selected *ex ante*. The difference, however, is that the second case is self-correcting—the new law can be repealed—while in the first the law is not enacted.

trade reform is often opposed by a majority *ex ante* but often obtains strong support *ex post*.⁶⁵ Pressure from mobile resources may push the political leader in the direction of efficient policies, but only if these can get majority support.

Accountability relationships at the state level in India illustrate the second inefficiency in electoral competition. Members of a state-level legislative assembly must maintain good relationships with two groups to stay in power—their party and their constituents. First, in order to please party leaders and receive renomination in the next election, they must carefully build coalitions of support within the party and the civil service.⁶⁶ In addition, to appear valuable to party leaders, they seek to maintain strong ties with important groups of voters.⁶⁷ State-level political leaders sustain themselves not so much by claiming credit for successful policies, local prosperity, and the provision of public goods, but more often by providing favors, constituency service, pork, and other private goods for selected constituents.⁶⁸ Politicians must be perceived as strong advocates for their constituents, and they do this by inserting themselves as mediators between their constituents and a bureaucracy in which people have little trust.⁶⁹ People rely upon the mediation of politicians to procure such things as hospital beds, loans, jobs, permits, places in schools, irrigation projects, roads and repairs, even train reservations.⁷⁰ Where such mediation is an important source of political support, elected officials will have little interest in improving the performance of the bureaucracy.

Party leaders at the state level must be concerned not only with pleasing voters, but also with fighting factional battles within their

⁶⁵ Fernandez and Rodrik argue that in Taiwan, South Korea, Chile, and Turkey, reform was imposed by authoritarian regimes against the wishes of business. *Id.* at 1147. Once the policies were in place, business was the staunchest defender of the liberalized trade policies. *Id.*

⁶⁶ Frank de Zwart, *The Bureaucratic Merry-Go-Round: Manipulating the Transfer of Indian Civil Servants* 81 (1994).

⁶⁷ *Id.* at 101-02.

⁶⁸ See *id.*

⁶⁹ *Id.* at 102.

⁷⁰ Frank de Zwart reports that in Gujarat, every member of the legislative assembly writes daily requests asking the station master to provide a constituent with a reservation. *Id.*

own parties. A state chief minister must be careful to maintain the support of the members of the legislative assembly ("MLAs") by exchanging political favors for political support.⁷¹ At the same time, he or she wants to ensure that these members can win reelection. Manipulation of civil service transfers is an extremely important political tool in this kind of coalition politics.⁷²

One of the most important resources available to political leaders in the Indian states is the ability to order the transfer of civil servants to new posts in different parts of the state.⁷³ Civil servants constantly lobby for favorable transfers or against unfavorable ones, and since many civil servants earn extra money through corrupt practices, they are able and willing to pay.⁷⁴ These payments make up an important source of income for MLAs, who use the money to run expensive election campaigns.⁷⁵ State chief ministers distribute power over civil service transfers in exchange for the support of MLAs, who in turn use the transfers to procure favors from bureaucrats for selected constituents as well as money for themselves and their campaigns.⁷⁶ Needless to say, this system does not result in efficiency and good long-term planning. Party leaders do have some interest in an efficient bureaucracy and do sometimes attempt to lessen the frequency of transfers. Indeed, the prevalence of transfers is criticized by almost everyone, including MLAs, but would-be reformers face a dilemma similar to that faced by would-be reformers of the system of patronage in Latin America: Reform aimed at creating a more impartial and efficient bureaucracy is difficult to achieve

⁷¹ *Id.* at 7. See also Paul R. Brass, *Factional Politics in an Indian State: The Congress Party in Uttar Pradesh* 235-37 (1965) (describing the importance of the distribution of benefits in maintaining factions); Mary C. Carras, *The Dynamics of Indian Political Factions: A Study of District Councils in the State of Maharashtra* 13-15 (1972) (same).

⁷² See, e.g., de Zwart, *supra* note 66, at 7; David C. Potter, *India's Political Administrators, From ICS to IAS* 150-58 (rev. ed. 1996); Robert Wade, *The Market for Public Office: Why the Indian State Is Not Better at Development*, 13 *World Dev.* 467, 484-89 (1985) [hereinafter Wade, *The Market*]; Robert Wade, *Politics and Graft: Recruitment, Appointment, and Promotions to Public Office in India*, in *Corruption, Development and Inequality: Soft Touch or Hard Graft?* 73, 76-82 (Peter M. Ward ed., 1989) [hereinafter Wade, *Politics and Graft*].

⁷³ Civil servants are transferred very often. De Zwart, *supra* note 66, at 55-56.

⁷⁴ *Id.* at 7.

⁷⁵ *Id.*

⁷⁶ *Id.*

because each actor fears that he will place himself in a disadvantageous position if he refrains from manipulating transfers.⁷⁷ Many students of underdevelopment in India argue that corruption, rent-seeking, and clientelistic politics are among the most important impediments to development.⁷⁸

Montinola, Qian, and Weingast argue that decentralized federalism in developing societies leads to lower levels of success for rent-seekers.⁷⁹ They suggest that instead of resulting in efficiency losses, self-seeking among local leaders has a positive spillover: prosperity for the entire region.⁸⁰ The implications for India are clear—decentralization aimed at the MPF ideal should lead to fewer rents, less corruption, and more credible commitments to markets. In order for Weingast's argument to be correct, exit threats made by mobile constituents must be extremely important to state-level political leaders, who must be punished for failing to respond to them.

As seen above,⁸¹ however, state-level leaders in India are rewarded rather than punished for providing private goods to important constituents. Even if the Indian federation were severely decentralized and states were completely responsible for their own tax and regulatory regimes, there is little reason to believe that these incentives would change. If decentralization allowed state-level leaders more control over the profits earned by public enterprises, it does not necessarily follow that they would maximize long-term revenue by investing in making them more productive, as Montinola, Qian, and Weingast argue for the Chinese case.⁸² In a competitive political environment, they may be more inclined to use the new revenue to buy off potential opponents or others who are in a position to claim some of the spoils for themselves. Similarly, it may be politically rational to use

⁷⁷ See Barbara Geddes, *A Game-Theoretic Model of Reform in Latin American Democracies*, in *Politics and Rationality* 165 (William James Booth, Patrick James & Hudson Meadwell eds., 1993).

⁷⁸ See, e.g., Pranab Bardhan, *The Political Economy of Development in India* 60-74 (1984) [hereinafter Bardhan, *Political Economy*]; Bardhan, *supra* note 10, at 24-26; Wade, *The Market*, *supra* note 72, at 485-86.

⁷⁹ Montinola, Qian & Weingast, *supra* note 12, at 58.

⁸⁰ *Id.* at 59.

⁸¹ See *supra* notes 66-70 and accompanying text.

⁸² Montinola, Qian & Weingast, *supra* note 12, at 64.

public enterprises and their revenue streams to build coalitions and help important allies.⁸³

Moreover, state-level leaders in a more decentralized system will not necessarily be responsive to the threats of mobile asset holders. In a democracy it is necessary to compete for the votes of immobile groups, which often leads to policies that displease potential mobile investors.⁸⁴ In many of the Indian states, agricultural interests are extremely important holders of immobile assets who are likely to mobilize to express their views, and therefore often dominate state-level politics.⁸⁵ The states have more independent control over agricultural affairs than any other policy area, and state-level parties often seek political support by providing political favors for farmers such as waiving interest on farm loans,⁸⁶ heavily subsidizing agricultural products,⁸⁷ and providing subsidized electricity.⁸⁸

Even if interjurisdictional competition for capital and labor places strong constraints on regional or local leaders, and if the interests of mobile constituents (or even mobile outsiders) consistently win out over those with higher moving costs, it seems likely that in a democracy like India, political entrepreneurs will attempt to mobilize the apparent losers. This kind of political entrepreneurship partially explains the electoral strategies of right-wing parties like Shiv Sena in Maharashtra state.

Shiv Sena was founded in 1966 to organize unemployed youth in Maharashtra to protest against outsiders—usually Indians from southern states such as Tamil Nadu, Kerala, and Karnataka—

⁸³ Susan L. Shirk, *The Political Logic of Economic Reform in China* 152-54 (1993) (detailing the consequences of fiscal decentralization in China and arguing that local officials used their financial authority to build political machines for themselves and subsequently developed interests in blocking further market reforms that would have diminished their own control over enterprises).

⁸⁴ This is the intuition behind a recent model of federalism by Jean-Luc Migué based on the Canadian case. See Jean-Luc Migué, *Public Choice in a Federal System*, 90 *Pub. Choice* 235 (1997).

⁸⁵ See Varshney, *supra* note 57, at 178-80.

⁸⁶ Shiraz Sidhva, *Indian Bank Warns on Rash Poll Pledges*, *Fin. Times*, Feb. 7, 1995, available in LEXIS, News Library, Fintme File.

⁸⁷ *Id.*

⁸⁸ *Indian Minister Raps States for Resisting Reforms*, *Reuters World Service*, March 4, 1995, available in LEXIS, News Library, Reuwld File [hereinafter *Indian Minister*].

who were taking jobs in Bombay.⁸⁹ As demonstrated by parties such as Shiv Sena and the Bharatiya Janata Party (“BJP”), linguistic or ethnic ties can be particularly useful building blocks for political entrepreneurs who are attempting to build electoral coalitions.⁹⁰ These parties tried to discredit the Congress Party government of Maharashtra by portraying it as incapable of protecting the interests of the Hindu majority against those of various “outsiders.”⁹¹ This kind of political entrepreneurship, combined with natural impediments like language, culture, and moving costs, leads to significant barriers to labor mobility throughout India.⁹² In decentralized systems characterized by strong communal loyalties, political challengers often face incentives to portray themselves as the voice of the immobile and the loyal, and incumbents as the corrupt partners of mobile groups of investors and laborers. Incumbents in turn face pressures to respond to these charges and actively assemble their own coalitions of less mobile supporters.

In 1995, a coalition made up of the BJP and Shiv Sena replaced the previous Congress Party government in Maharashtra.⁹³ The new coalition quickly delivered on a campaign promise and called off a project to build a 2450-megawatt power plant—the largest power project in Asia—after the American multinational Enron Corporation had already invested millions of dollars.⁹⁴ This was a blatant violation of an agreement made less than one year earlier between Enron and the previous Congress government.⁹⁵

⁸⁹ Shiraz Sidhva, Survey—Maharashtra 1996: Tiger’s Fangs Are Blunted, *Fin. Times*, July 11, 1996, at 2, available in LEXIS, News Library, Fintme File.

⁹⁰ *Id.*

⁹¹ Clarence Fernandez, India Hindu Party to Broaden Appeal Ahead of Poll, *Reuters World Service*, Nov. 19, 1995, available in LEXIS, News Library, Reuworld File.

⁹² Paul Cashin & Ratna Sahay, Regional Economic Growth and Convergence in India, *Fin. & Dev.*, Mar. 1996, at 49, 52.

⁹³ Sidhva, *supra* note 86.

⁹⁴ See Mark Nicholson, Survey—Maharashtra 1996: U-Turn That Saved the Project, *Fin. Times*, July 11, 1996, at 3, available in LEXIS, News Library, Fintme File; Jayanta Sarkar, Letter from India: Political Balkanization Continues to Poison IPP Environment, *Electrical World*, Nov. 1996, at 66, available in LEXIS, Energy Library, Elecworld File; A Christmas Gift for Enron—and Some Costs to Consider, *Power Asia*, Dec. 9, 1996, available in LEXIS, Asiapc Library, Pasia File [hereinafter A Christmas Gift].

⁹⁵ A Christmas Gift, *supra* note 94.

The new coalition, fulfilling a campaign promise, argued that the terms of the agreement were too costly and made allegations of corruption.⁹⁶

The deal was eventually renegotiated, but the costs of the delay have been considerable.⁹⁷ The BJP-Shiv Sena coalition was able to save face by gaining some concessions from Enron,⁹⁸ but these gains seem to be offset by the costs associated with the delay, the lack of expected job creation, and the continuing undersupply of power.⁹⁹ Perhaps the most important cost of the Enron affair for India as a whole, however, is the fact that it has undermined the credibility of commitments for foreign investors in electrical power,¹⁰⁰ and has captured the attention of potential investors throughout the world in other sectors as well.¹⁰¹ Some believe the events in Maharashtra have put the brakes on other proposed foreign-sponsored independent power projects throughout India.¹⁰² The BJP-Shiv Sena coalition may have planned all along to renegotiate the contract because the complete abandonment of the project would have had disastrous economic and political consequences. Nevertheless, after waging a campaign that included strong rhetoric against outsiders, the coalition needed a way to maintain the credibility of its irresponsible campaign commitments. It did this by sacrificing the credibility of commitments made to Enron by its predecessors.

The general problem of credible commitments extends beyond the specific case in Maharashtra. Once an investor's sunk costs reach a certain threshold, its exit threats are no longer credible, and local political leaders can renege on earlier agreements and attempt to extract extra concessions.¹⁰³ While this kind of behav-

⁹⁶ Nicholson, *supra* note 94.

⁹⁷ A Christmas Gift, *supra* note 94.

⁹⁸ These include a reduced capital cost, a more favorable power purchase agreement for the state power authorities, and a better package of environmental protection. There is considerable disagreement about the value of the concessions. See *id.*

⁹⁹ *Id.*

¹⁰⁰ See Sarkar, *supra* note 94.

¹⁰¹ Vivek Y. Kelkar, Maharashtra Promotes Itself in Post-Enron Era, *Asia Times*, Feb. 17, 1997, at 4, available in LEXIS, News Library, Asiatm File.

¹⁰² See A Christmas Gift, *supra* note 94.

¹⁰³ See Raymond Vernon, *Sovereignty at Bay: The Multinational Spread of U.S. Enterprises* 46-59 (1971) (arguing that foreign investors face the problem of the

ior will damage the reputation of the state and potentially hinder future investment, state leaders in highly competitive political environments may not have the luxury of long time horizons. In the short term, it may be politically rational to make confiscatory demands of investors after their sunk costs are significant. The rents may be used to finance election campaigns or pay off important groups of politicians or constituents. Indeed, if inter-governmental budget constraints are as hard as Weingast's MPF model advocates, foreign investors may become the only available source of resources if local leaders are pressed for funds.

B. Authoritarian Systems

The analysis above relies heavily on the democratic nature of the Indian state. We have used the case of an electoral democracy to illustrate the way political accountability relationships may limit the influence of exit threats on policy decisions. Thus, since MPF is consistent with rent-seeking assumptions about politicians and leaves questions of political accountability unexplored, perhaps an imperfect MPF would work best with unabashed kleptocrats in charge of lower-level governments.

Such a conclusion seems unsound for two reasons. First, even in authoritarian systems, political leaders must pacify or maintain the support of some relatively immobile constituents by providing beneficial policies or patronage. For instance, an authoritarian leader may find it necessary to pacify large groups like urban constituents, whose collective action costs are relatively low, by maintaining artificially low food prices.¹⁰⁴ Authoritarian leaders must also build coalitions among political elites by bestowing patronage and private benefits. In contrast to Montinola, Qian, and Weingast, Susan Shirk argues that local political officials in China should be viewed as engaged primarily in creating sys-

"obsolescing bargain," whereby the bargaining strength of the host country increases over time). See also Jonathan Thomas & Tim Worrall, *Foreign Direct Investment and the Risk of Expropriation*, 61 *Rev. Econ. Stud.* 81 (1994) (presenting a formal model of this problem).

¹⁰⁴ See Robert H. Bates, *Markets and States in Tropical Africa: The Political Basis of Agricultural Policies* 81-95 (1981) (discussing African states' favoritism of urban over rural constituencies).

tems of patronage and loyalty in order to maintain power.¹⁰⁵ Even the most apparently kleptocratic, unaccountable leader generally cannot be a pure rent-maximizer, and even to the extent that a kleptocrat can develop an encompassing interest in the prosperity of the jurisdictional unit, he or she may be forced to respond to strong immobile groups to stay in power.

Second, even if local leaders are pure kleptocrats, competition among them would not necessarily produce the efficient results posited by MPF. Decentralization can instead produce inefficient, competitive rent-seeking. The pool of rents produced by a political-economic system can be viewed as a common pool that will be overfished by competing public officials.¹⁰⁶ A decentralized system of government can have just this structure. In such cases, competition does indeed dissipate rents, but with no corresponding economic benefits. Instead, individual public officials and investors engage in a wasteful struggle to appropriate the gains.¹⁰⁷ Thus one's view of the value of interjurisdictional competition depends upon whether it is analogous to a competitive market with states as sellers and firms as buyers, or whether it is like competitive rent-seeking in a common pool. In Weingast's view, mobile capital uses its threat of exit to assure an efficient business environment even when politicians seek corrupt payoffs. In contrast, we argue that corrupt government officials will often face lucrative, but inefficient, rent extraction possibilities.

¹⁰⁵ Shirk, *supra* note 83, at 182-84, 187-90. Shirk argues that decentralization "created a situation in which both local officials and enterprise managers concentrated on rent-seeking rather than economic returns." *Id.* at 188. Local officials were able to collect rents from subordinates and enterprise managers, building up "political capital by allocating benefits selectively and imposing costs uniformly." *Id.* She describes "local political machines" in which local party secretaries exchanged economic favors for political loyalty. *Id.* at 189. In Shirk's analysis, local party and government authorities used rents above all to further their own political careers.

¹⁰⁶ The classic discussion of the common pool problem is Garrett Hardin, *The Tragedy of the Commons*, 162 *Sci.* 1243 (1968).

¹⁰⁷ An analogous problem within a single government is described in Andrei Shleifer & Robert W. Vishny, *Corruption*, 108 *Q.J. Econ.* 599, 604-11 (1993). They show that bribes are higher and output lower with uncoordinated corrupt agents supplying complementary goods than with corrupt monopolistic rulers. The key point, as Shleifer and Vishny note, is the inability of businesses and individuals to avoid corrupt demands by turning to another official. *Id.* at 606-07.

For example, suppose that the petroleum industry in a country produces excess profits. Officials of subnational governments within the country may try to appropriate some of these rents with legal taxes and illegal bribery demands. Officials might demand bribes for letting the petroleum pass through their territory, or state governments might levy sales taxes. Weingast might want to define such actions out of existence as inconsistent with MPF's common market requirement, but if such rents do exist in society, it will take a subtle and complex set of well-enforced laws to avoid the problem. Even in China—Weingast's main example of a state that approximates an MPF—competitive rent-seeking is a serious problem.¹⁰⁸

In addition, the decentralized structure of government itself introduces inefficiencies into the rent-seeking process. It is true that a unitary state could simply levy a profits tax, and of course, a single, high-level kleptocrat may be more dangerous than several low-level ones simply because he has greater power over the state.¹⁰⁹ Nevertheless, decentralization of the government structure is unlikely to be a valuable anticorruption policy if the underlying rent-generating possibilities of the economy remain intact. Now instead of a single kleptocrat, there are a multitude, all expending resources to appropriate gains for themselves at the expense of rival politicians. Pranab Bardhan argues that “a weak central government with its inability to stop the setting up of independent corruption rackets (a kind of economic warlordism) makes the problem of inefficiency particularly acute.”¹¹⁰

Thus we conclude that the problem of credible commitments to markets may be just as great or greater in decentralized federal systems. Contrary to Weingast's argument, political incentives at the local or regional level may exaggerate the problems of rent-extraction, corruption, and confiscation. Even when the

¹⁰⁸ See Jun Ma, *Macroeconomic Management and Intergovernmental Relations in China* 52-57 (World Bank, Pub. Econ. Div. Working Paper No. 1408, 1995).

¹⁰⁹ See Susan Rose-Ackerman, *Reducing Bribery in the Public Sector*, in *Corruption & Democracy: Political Institutions, Processes and Corruption in Transition States in East-Central Europe and in the Former Soviet Union* 21, 25 (Duc V. Trang ed., 1994).

¹¹⁰ Pranab Bardhan, *The Economics of Corruption in Less Developed Countries: A Review of Issues* 9 (Ctr. for Int'l & Dev. Econ. Research Working Paper No. C96-064, 1996).

exit threats of mobile resources are credible, their influence will often not be powerful enough to override the impact of political goals and political institutions.

III. IS MARKET-PRESERVING FEDERALISM POLITICALLY SUSTAINABLE?

In the preceding discussion, we added political and institutional reality to the MPF model and concluded that federalism does not necessarily prevent subnational leaders from pursuing inefficient confiscation and interfering with markets. Indeed, MPF-style decentralization introduces new problems for developing countries. Self-seeking policies among state and local leaders can lead to a variety of new inefficiencies. This Part addresses some of the costs of decentralization and argues that if we consider political goals and institutions, an MPF is a highly unstable institutional equilibrium. If the central government in a market-preserving federation cannot mitigate some of the costs of decentralization, it may not be able to survive. However, even if it *is* capable of overcoming these inefficiencies, it is unlikely to meet the most important requirements of the MPF model. While Part II argued that MPF does not provide adequate political foundations for limitations on state and local leaders, this Part argues that it provides no political foundation for a stable limited central government.

When subnational leaders have a significant amount of autonomy from the center, individually rational actions by those leaders can aggregate into inefficient outcomes at the national level. For instance, regional leaders may face political incentives to create barriers to interjurisdictional factor mobility and to impose significant costs on other jurisdictions. In addition, public goods with interjurisdictional spillovers may be underprovided. Most students of federalism argue that the central government must play some role in solving interjurisdictional problems of coordination and in supplying public goods. Weingast and his collaborators are no exception. The MPF model stipulates, for instance, that the central government should police the common market across regions and provide certain national public goods,

like monetary policy, that the subnational governments would not be able to provide.¹¹¹

Weingast and his collaborators deal with the problem of decentralization costs by way of assumption. They argue, as a normative matter, that the central government should be severely limited, but that it should also be capable of easing the costs associated with decentralization.¹¹² The model does not, however, take on the difficult task of providing institutional microfoundations for such a dual federation; it simply assumes that MPF is a sustainable political equilibrium. We argue here that if political incentives are considered, it may not be possible to achieve the decentralization necessary for MPF while preserving the ability of the central government to overcome the costs of decentralization. If decentralization is sufficiently complete to bring about the demand-side competitive pressures upon which the market-preserving argument is based, the institutions on the supply side will be affected. Decentralization can not only create opportunities for private goods provision and rent-seeking at the subnational level; it may also prevent the central government from mitigating the inefficiencies created by the uncoordinated self-seeking policies of subnational units. These inefficiencies can create serious impediments to development and growth. If a central government is strong enough to solve these problems, however, it is unlikely to meet the MPF requirements. Thus, the fiscal and regulatory tools necessary to overcome the costs of decentralization are not consistent with MPF's regulatory criteria. We develop this argument by examining several potential problems associated with MPF-style political decentralization: 1) local protectionism and cost exportation; 2) a possible growth in interjurisdictional inequality; and 3) the inefficient provision of public goods.

A. Local Protectionism and Cost Exportation

Subnational political leaders in decentralized systems often face incentives to block the flow of capital, goods, and labor across jurisdictional lines. Weingast and his co-authors examine

¹¹¹ Montinola, Qian & Weingast, *supra* note 12, at 55.

¹¹² See *id.*

this problem in the Chinese case and acknowledge that protectionism allows local governments to insulate themselves from the pressure of competitive federalism, which may make room for corruption and rent-seeking at the local level.¹¹³ Since local governments in China rely heavily on the profits earned by locally-owned enterprises, they face strong incentives to maximize the profits of these enterprises. Responding to those incentives, local leaders in China frequently limit imports, monopolize sales, and tax exports.¹¹⁴ Thus the very features of the Chinese case that would make it a good example of MPF also contribute to protectionist incentives. “[D]ecentralization has increased the incentives as well as the range of political means for local governments to erect trade barriers, resulting in the so-called dukedom economies phenomenon, which has worried the central government and economists.”¹¹⁵ This kind of behavior introduces serious market distortions. “The gains in interregional trade from specialization and scale were lost as the national market was segmented by administrative barriers.”¹¹⁶

Although state-level leaders in India have less autonomous power than provincial and local officials in China, they are also able to respond to political incentives by constraining the free flow of goods, capital, and labor across jurisdictional boundaries. As described above,¹¹⁷ political entrepreneurs may employ anti-investment nationalism as an electoral strategy. Politically-induced barriers to labor market mobility are common; strong local and regional workers’ unions have been very successful in

¹¹³ *Id.* at 66.

¹¹⁴ See David S.G. Goodman, *The Politics of Regionalism: Economic Development, Conflict and Negotiation*, in *China Deconstructs: Politics, Trade and Regionalism* 1, 6-7 (David S.G. Goodman & Gerald Segal eds., 1994); Ma, *supra* note 108, at 53-54; Yi Zhao, *Local Governments and the Enforcement of the Tax and Contract Laws in China* 4-5 (1997) (unpublished manuscript, on file with the Virginia Law Review Association).

¹¹⁵ Montinola, Qian & Weingast, *supra* note 12, at 65. Weingast and his collaborators cite a 1993 World Bank study that notes the tendency of individual provinces to behave as separate countries, rather than as parts of a single country. *Id.* at 65 n.27. See also Ma, *supra* note 108, at 53-55 (discussing barriers to interregional trade).

¹¹⁶ Shirk, *supra* note 83, at 186.

¹¹⁷ See *supra* notes 89-102 and accompanying text.

preventing potential competing employees from entering regional labor markets.¹¹⁸

Local protectionism is not the only problem. Interjurisdictional competition itself can also be inefficient. The roots of Weingast's demand-side arguments lie in accounts of interjurisdictional competition that stress its efficiency-enhancing attributes.¹¹⁹ Interjurisdictional competition also, however, provides incentives for subnational units to produce externalities that favor local businesses and citizens and export costs onto others. For instance, states may allow industries located on their borders to release pollutants whose damaging effects harm neighboring states.

A less obvious example arises from interjurisdictional tax competition. Given that capital is often more mobile than labor, it would be rational for the representatives of each jurisdiction to engage in tax competition to attract investments to their respective jurisdictions. Indeed, this is exactly what Weingast and his co-authors might seek to encourage. However, some of the tactics governments can use are inefficient. For example, a government may seek to export the burden of financing public services to other jurisdictions. If successful, this will result in underpriced public services in the taxing jurisdiction and can create price distortions in product markets and barriers to factor and product mobility.¹²⁰

It is true that the smaller a government jurisdiction, the more difficulty it ought to have in exporting taxes. There are two reasons for this: 1) Firms and people will move away from high tax jurisdictions; and 2) small jurisdictions are likely to have less market power than larger ones. Thus smaller jurisdictions are more likely to be price takers in both export and import markets. If the prices of the products produced in a jurisdiction are determined in national and international markets, immobile factors and the rents of local firms must absorb the tax bill. Similarly, if the prices for consumer goods are set in national markets, a local

¹¹⁸ Cashin & Sahay, *supra* note 92, at 52.

¹¹⁹ Brennan & Buchanan, *supra* note 45, at 184-86; Alessandra Casella & Bruno Frey, *Federalism and Clubs: Towards an Economic Theory of Overlapping Political Jurisdictions*, 36 *Eur. Econ. Rev.* 639, 641-45 (1992).

¹²⁰ For a discussion of the Indian case, see M. Govinda Rao & François Vaillancourt, *Interstate Tax Disharmony in India: A Comparative Perspective*, *Publius*, Fall 1994, at 99, 100.

tax will be fully borne by the jurisdiction in the form of higher prices and reduced demand. Thus when the central government devolves taxing powers to smaller state and local governments, these governments ought to have limited opportunities for tax shifting.

Nonetheless, such governments will try to take advantage of the opportunities that remain. Any local monopoly power within the jurisdiction can be a locus for the export of taxes. In such cases, the *smaller* the size of the jurisdiction, the greater its ability to export costs. For example, consider a coastal enclave with a major port that serves a large hinterland that is not part of its jurisdiction. Such a city has an incentive either to tax port operations to finance its own government or to run the port as a monopoly public corporation to extract rents. Notice that, so long as productive efficiency does not suffer, shippers will be indifferent between an untaxed private monopoly and a monopoly providing benefits directly to the state. Both will maximize monopoly profits by setting prices too high and quantity too low. Taxes are exported only in the sense that private monopoly profits flow into the government's coffers. Although shippers do not pay a higher price when the port is a public enterprise, there *is* a sense in which they bear the costs of the fragmented jurisdictional structure. Incorporating the hinterlands and the port city into a single jurisdiction would produce pressure from shippers for an antimonopoly policy to regulate the port. In the fragmented case, the port city has no such incentive to take shippers' interests into account except as they are reflected in the prices the shippers are willing to pay.

Thus, the important issue is not the export of taxes per se, but whether a small jurisdiction can ignore the interests of those who would benefit from a more competitive organization of a local market. Governments that include within their borders most of the suppliers in a single industry have an incentive to facilitate their monopolization as a revenue generation device. Producers have an incentive to go along with this effort so long as their net profits increase. The examples include not just key bottleneck services such as ports or bridges, but also scarce raw materials. A government that includes the country's petroleum supply may facilitate the cartelization of the local industry so long

as production costs are low enough to generate monopoly rents in the world market. Note, however, that unless the country's citizens are themselves important users of the product, the national government will have exactly the same incentives to extract monopoly rents.¹²¹

In India, sales taxes are levied by state governments. Unlike sales taxes in such countries as the United States and Canada, taxes are levied at the first point of sale by a producer or importer, not at the point of sale to the end user.¹²² Indian tax rates diverge widely across the states, and the divergence has *increased* over time.¹²³ This result, puzzling to a defender of competitive federalism, may imply that some states have monopoly power in the production or import of certain commodities.

This range of difficulties is handled by stipulation in Weingast's model. He and his collaborators require that in a perfect MPF: "The national government has the authority to police the common market and to ensure the mobility of goods and factors across subgovernment jurisdictions."¹²⁴ The Chinese case makes it clear that this is no small task.¹²⁵ Given the prevalence and difficulty of the problem, the model must do more than simply state that it would be solved in an ideal federation. Weingast does not consider that the ability of the central government to police the common market may be directly related to the strength of its fiscal and regulatory powers. Indeed, the fact that Weingast leaves the task of policing the common market to the central government rather than the subnational leaders suggests that the underlying structure of the problem is a prisoner's dilemma requiring an external solution, not a coordination game requiring only communication or the determination of a focal point. The federal government must help the subunits reach a collaborative open-market solution and be empowered to punish defectors.

¹²¹ The dynamic is identical to that described by Richard Lotspeich in discussing private extortion markets in Russia in which Mafia-like groups assist firms in monopolizing certain markets for a fee. See Richard Lotspeich, *An Economic Analysis of Extortion in Russia* 21-26 (Nov. 1996) (unpublished manuscript, on file with the Virginia Law Review Association).

¹²² Rao & Vaillancourt, *supra* note 120, at 112-13.

¹²³ *Id.* at 111-12.

¹²⁴ Montinola, Qian & Weingast, *supra* note 12, at 55.

¹²⁵ See *supra* notes 113-116.

In order to play this role, the federal government must be quite strong, especially in large and complex systems like China and India. It must have an array of tools with which to reward and punish subnational governments. Yet the MPF model seems to leave the central government with neither fiscal nor regulatory carrots or sticks. Devolution of political authority in China has gone so far that many question the central government's ability to collect revenue and implement laws.¹²⁶ Fiscal devolution in China has given local governments the responsibility of assessing and collecting taxes from their own enterprises, which means that local governments apply the tax laws to themselves.¹²⁷ This can lead to lax law enforcement and revenue problems for the central government. If MPF-style devolution strips the central government of the ability to raise adequate revenue and oversee law implementation and enforcement at the local level, it is unlikely that the central government will be in a position to enforce an interjurisdictional common market.

Many scholars have stressed the weakness of central governments in large developing countries such as Brazil and India.¹²⁸ Despite the fact that the center is in a strong institutional position vis-à-vis the states in India,¹²⁹ central leaders have lost con-

¹²⁶ Donald C. Clarke, *What's Law Got to Do with It? Legal Institutions and Economic Reform in China*, 10 *UCLA Pac. Basin L.J.* 1, 13-15, 69-76 (1991); Yufan Hao & Michael Johnston, *Reform at the Crossroads: An Analysis of Chinese Corruption*, *Asian Persp.*, Spring-Summer 1995, at 117, 123-25, 131-34; Zhao, *supra* note 114, at 21-22.

¹²⁷ Ma, *supra* note 108, at 9-14; Zhao, *supra* note 114, at 22.

¹²⁸ See, e.g., Joel S. Migdal, *Strong Societies and Weak States: State-Society Relations and State Capabilities in the Third World* 206-37 (1988); Frances Hagopian, *Traditional Politics Against State Transformation in Brazil*, *in* *State Power and Social Forces* 37 (Joel S. Migdal, Atul Kohli & Vivienne Shue eds., 1994); Atul Kohli, *Centralization and Powerlessness: India's Democracy in a Comparative Perspective*, *in* *State Power and Social Forces*, *supra*, at 89.

¹²⁹ The Indian Constitution grants a great deal of political and economic power to the center. Although devolutionary reform proposals are common, see *supra* note 22, New Delhi maintains the power to allocate resources between itself and the states. Most taxes are levied by and accrue to the center. Paul Cashin & Ratna Sahay, *Internal Migration, Center-State Grants, and Economic Growth in the States of India*, 43 *IMF Staff Papers* 123, 127-28 (1996). In addition, the center can borrow from international markets, while the states rely on the permission of the central government to borrow domestically. *Id.* For overviews, see P.K. Bhargava, *Centre-State Resource Transfers in India* (1982); Cashin & Sahay, *supra*; I.S. Gulati & K.K. George, *Inter-State Redistribution Through the Budget*, *in* *Centre-State Budgetary Transfers*

trol of some of the levers with which they controlled local leaders in the past. Older patterns of political control, in which leaders of the dominant Congress Party at the national level influenced state and local leaders through patronage and appointment powers, have declined.¹³⁰ Without strong fiscal and regulatory tools, political pressure may not be enough to bring about compliance given today's fragmented, regionalized Indian party system. Similarly, if Argentina, Brazil, or India were to embark on devolution programs in the spirit of MPF, which Weingast seems to recommend,¹³¹ their central governments' ability to police a common market would be limited at best.

Of course, it is possible for a well-enforced common interjurisdictional market to exist in a decentralized federal system. We only want to stress that such a balance is difficult to achieve and sustain. Although historical examples are not easy to find, Weingast is correct in arguing that the United States before the New Deal seems to have maintained this delicate balance.¹³² The states had primary control over their economies, but the interpretation and enforcement of the Commerce Clause preserved a common market between the states.¹³³

Why was the United States able to preserve this balance? As Weingast points out, the regional distrust generated by slavery played an important role in facilitating the stability of decentralization.¹³⁴ Additionally, the political entrepreneurship of the Jacksonian Democrats called for a limited central government and a constitutional jurisprudence of states' rights.¹³⁵ Specifically, they manipulated political institutions in three ways to create incentives for officials to implement their policies. First, they

267 (I.S. Gulati ed., 1987). Perhaps the most important and unusual power of the central government is the appointment of the state governors by the president (on the advice of the prime minister). See Ramesh Thakur, *The Government and Politics of India* 86-87 (1995). The prime minister can also instruct the president to declare an emergency in a state and dismiss the entire state government—a power that has been used frequently. See *id.* at 83-86; Krishna K. Tummala, *India's Federalism Under Stress*, 32 *Asian Surv.* 538, 541-44 (1992).

¹³⁰ See Kohli, *supra* note 128, at 89-90.

¹³¹ See Weingast, *supra* note 11, at 28.

¹³² Weingast, *supra* note 7, at 294-96.

¹³³ See *id.*

¹³⁴ Weingast, *supra* note 11, at 18-21.

¹³⁵ *Id.* at 20.

appointed states' rights advocates to the Supreme Court.¹³⁶ Second, they adopted the two-thirds rule for nominating presidential candidates, which gave Southerners a veto over their party's presidential candidate.¹³⁷ Third, the balance rule gave the South a veto over national policy through its equal representation in the Senate.¹³⁸

In short, the explanation for the simultaneous fulfillment of the decentralization and common market requirements for MPF in the United States seems to lie in a unique, contingent mixture of institutional constraints and political entrepreneurship. This mixture changed dramatically in the 1930s. President Franklin Roosevelt's political entrepreneurship relied on the mobilization of national-level groups whose interests were advanced by new interpretations of the Commerce Clause and a much more powerful central government.¹³⁹ Ever since the institutional and jurisprudential innovations of the 1930s, the American federal system has borne little resemblance to an MPF. The common market condition is perhaps the only MPF requirement met by the United States today. Yet the process does not appear to be reversible. The efforts at devolution supported by the Reagan administration in the 1980s hardly fit with Weingast's ideal. Like other new federalism rhetoric, they seemed based on political expediency rather than principle.¹⁴⁰

When the central government in a federal system successfully maintains a common market in which labor, capital, and goods flow freely over state lines over a sufficiently long period of time, a national economy emerges. This creates the possibility that groups which cannot achieve their policy goals by either political mobilization or the threat of exit at the state level may seek to voice them at the national level. This increases the likelihood that a political entrepreneur will seek to mobilize such latent national interest groups. As the New Deal case demonstrates, these

¹³⁶ *Id.*

¹³⁷ *Id.*

¹³⁸ *Id.*

¹³⁹ See Bruce Ackerman, *We the People: Transformations*, chs. 10-12 (forthcoming 1998) (discussing the constitutional transformation brought about by the New Deal).

¹⁴⁰ See Susan Rose-Ackerman, *Rethinking the Progressive Agenda: The Reform of the American Regulatory State 159-73* (1992).

policy goals are likely to involve national-level regulations that are hostile to the MPF ideal. In other words, sustained enforcement of MPF's common market requirement will, under plausible conditions, undermine the credibility of the decentralization requirement. Correspondingly, as the Chinese case shows, sustained credible decentralization may destroy the common market. It may be quite difficult for a developing country to strike the appropriate balance.

B. Growing Interjurisdictional Inequality

If the jurisdictional units in an MPF are not sufficiently homogeneous, interjurisdictional competition may exacerbate inequalities rather than reduce them. Suppose that mobile resources move from jurisdiction *A* to jurisdiction *B* in response to better economic opportunities in *B*. In a simple production function with diminishing returns to scale, this will raise wages and lower rates of return in *B* relative to *A*. Eventually economic opportunities in the two jurisdictions will be equalized at the margin. Suppose, however, that network externalities or economies of scope exist so that later investors have an incentive to follow those who came first. Community *B* can then continue to attract investors who benefit both from the growing network of contacts and the improved infrastructure quality that massed private investment makes possible. Although many are skeptical about theoretical and empirical accounts of unstable competition in developed federations like the United States and Canada,¹⁴¹ most acknowledge that a problem exists at the municipal level.¹⁴² Mobile high-income residents and businesses have exited city centers with their concentration of poor households, abandoned neighborhoods, and aging infrastructure.¹⁴³ In the absence of redistributive policies, it is not difficult to envision highly

¹⁴¹ See, e.g., John E. Chubb, *How Relevant Is Competition to Government Policy-making?*, in *Competition Among States and Local Governments*, supra note 45, at 57, 60-62 (arguing that there is very little direct evidence to show that interjurisdictional competition places important constraints on the behavior of state leaders).

¹⁴² See, e.g., Katherine L. Bradbury, Anthony Downs & Kenneth A. Small, *Urban Decline and the Future of American Cities* 10-11 (1982); James Heilbrun, *Urban Economics and Public Policy* 184-85 (1974).

¹⁴³ Heilbrun, supra note 142, at 184-85.

skewed intergovernmental competition in a developing society like India if MPF-style reforms were implemented. Vast differences in resources and development separate the Indian states, and regional inequalities are growing.¹⁴⁴ If some states can export tax burdens and offer mobile capital enticements such as tax breaks or technology centers while other states cannot, it is likely that the former will be consistent winners in competitive struggles. In the absence of intergovernmental grants, underdeveloped states like Bihar could not compete with industrialized states like Maharashtra.

A skewed equilibrium concentrating most productive activities in a handful of jurisdictions may result from the following sources: differential migration costs for productive versus needy people; the ability of wealthy, growing jurisdictions to erect entry barriers against those who will require support; and the inability of poor jurisdictions to carry out growth-oriented strategies that impose costs on the needy. Poor jurisdictions may face a double disadvantage—politically they cannot abandon the short-term demands of the poor, and economically they may have few productive resources, poor infrastructure, and locational disadvantages. On the local level at least, competition aids those who start out ahead, and the laggards may not be able to promulgate catch-up policies.

Central governments in modern federations have developed a number of ways to deal with the problems of growing inequality that can result from local protectionism and cost exportation. For example, federal governments may provide fiscal and other incentives for subnational units to take account of externalities that impose costs on others, or they may use federal spending in areas like infrastructure development or defense to combat inequality.¹⁴⁵ While the methods vary from one federal system to

¹⁴⁴ Cashin & Sahay, *supra* note 92, at 50-51; Mahendra Prasad Singh, *Political Parties and Political Economy of Federalism: A Paradigm Shift in Indian Politics*, 7 *Indian J. Soc. Sci.* 155, 161 (1994); Payal Padmanabhan, *India-Economy: Some States Race Ahead, Rest Stay Poor*, *Inter Press Service*, Jan. 26, 1997, *available in* LEXIS, News Library, *Inpres* File; Sandwip Kumar Das & Alokesh Barua, *Regional Inequalities: Economic Growth and Liberalisation: A Study of the Indian Economy*, 32 *J. Dev. Stud.* 364, 364-69 (1996).

¹⁴⁵ See Albert Breton, *Competitive Governments: An Economic Theory of Politics and Public Finance* 248-54 (1996).

another, central governments play an important role in coordinating the activities of the jurisdictional units and monitoring and regulating competition between them.

Intergovernmental grants are one response to the problem of interjurisdictional inequality.¹⁴⁶ Canada, India, and Germany provide examples. To redress major differences in size, wealth, and economic development, the Canadian federal government provides intergovernmental grants and finances various regional development policies to ensure that poor provinces do not always lose competitive struggles over capital and labor.¹⁴⁷ Although they are often unsuccessful and poorly conceived, intergovernmental grants in India have also played a role in combating interstate inequalities. Without a strong redistributive role for New Delhi, interstate income disparities in India would likely be much higher.¹⁴⁸ The minimization of inter-jurisdictional income disparities is written directly into the German constitution, and German-style cooperative federalism has relied on large redistributive transfers among the *Länder* to accomplish the goal of "equivalent living conditions."¹⁴⁹

The various redistributive strategies employed by central governments to internalize externalities and stabilize interjurisdictional competition are commonly referred to as "cooperative federalism."¹⁵⁰ In modern federations like Australia, Canada, Germany, and the United States, the politics of transfers, mixed

¹⁴⁶ See *id.* at 254-58.

¹⁴⁷ See Philip J. Grossman & Edwin G. West, *Federalism and the Growth of Government Revisited*, 79 *Pub. Choice* 19 (1994) (arguing that intergovernmental transfers and regional development initiatives are a form of anti-competitive cartel between the provinces, with Ottawa acting as the enforcer and the provinces self-consciously delegating power to the federal government to lessen the extent of intergovernmental competition).

¹⁴⁸ See Cashin & Sahay, *supra* note 129, at 164 (finding that intergovernmental transfers have had some success in narrowing disparities in real per capita disposable income, while disparities in real state per capita incomes have widened).

¹⁴⁹ Grundgesetz [Constitution] art. 72, § 2, cl. 3 (F.R.G.). For commentary, see Charlie Jeffery, *The Non-Reform of the German Federal System After Unification*, 18 *W. Eur. Pol.* 252, 253-255 (1995); Uwe Leonardy, *To Be Continued: The Constitutional Reform Commissions from a Länder Perspective*, *German Pol.*, Special Issue, Dec. 1994, at 75, 91-92.

¹⁵⁰ See, e.g., Daniel J. Elazar, *Cooperative Federalism, in Competition Among States and Local Governments*, *supra* note 45, at 65.

financing, conditional grants, and intergovernmental bargaining serve to mitigate the negative effects of interjurisdictional competition. Although competition over mobile resources certainly continues in each of these federations, in each case it is regulated and stabilized either directly by agents of the federal government or by bargains struck between the agents of the jurisdictional units and those of the federal government.¹⁵¹ Indeed, modern federations do not meet the requirements for market-preserving federalism largely because their central governments play important redistributive roles that muddy the clear delineation of authority between governmental units, limit the autonomy of the sub-units, introduce soft budget constraints,¹⁵² and allow the allocation of authority to be altered frequently.

A pure MPF would be incapable of redistribution. Competitive subnational governments without a strong central government have little incentive to engage in redistribution to the poor.¹⁵³ If they engage in any redistribution at all, it is likely to be to the politically powerful.¹⁵⁴ Horizontal cooperative agreements, without the involvement of the federal government as a third party, are not likely to provide sustained solutions to interjurisdictional problems because such agreements are unlikely to be self-enforcing.¹⁵⁵ Short time horizons and incentives to cheat make inter-

¹⁵¹ See Chapman, *supra* note 34 (providing an overview of the variety of intergovernmental arrangements that serve to dampen competition between federated political units); Breton, *supra* note 145, at 250-58 (describing the role of federal governments in monitoring interjurisdictional competition).

¹⁵² See Ronald I. McKinnon, *Monetary Regimes, Government Borrowing Constraints, and Market-Preserving Federalism: Implications for EMU* 16-17 (unpublished manuscript, on file with the Virginia Law Review Association) (expanding on the importance of hard budget constraints at the state and local level and arguing that governments must be kept "on a short financial leash" if intergovernmental competition is to have a benign, market-preserving effect). McKinnon's normative arguments are convincing, but he does not specify the conditions under which hard budget constraints are politically sustainable at the local level. Above all, the problem of effectively preventing undue encroachment by "soft-budget" federal governments on "hard budget" lower-level governments looms large. See *id.*

¹⁵³ See Paul E. Peterson, *City Limits* 210-11 (1981) [hereinafter Peterson, *City Limits*]; Paul E. Peterson, *The Price of Federalism* 69-75 (1995) [hereinafter Peterson, *Federalism*].

¹⁵⁴ Peterson, *City Limits*, *supra* note 153, at 210-11.

¹⁵⁵ See Breton, *supra* note 45, at 49.

governmental cartels without federal enforcement unstable.¹⁵⁶ MPF's inability to facilitate redistribution and assuage the costs of decentralization not only creates the normative problems explored below,¹⁵⁷ but it also threatens to destroy the political viability of the model.

When the potential for skewed equilibria is high, a redistributive capacity for the central government is probably necessary for the political survival of a federal system. The kind of intertwined, complex cooperative federalism described above is almost universal in modern federations, as are complaints by self-proclaimed new federalists about federal usurpation of states' autonomy and the blurring of jurisdictional lines. Why does intertwined, cooperative federalism persist instead of the clearly delineated, decentralized authority structures described by Riker?¹⁵⁸ While we do not offer a general theory of cooperative federalism, we argue that it has evolved more as a self-interested political strategy than a conscious attempt to increase efficiency or fairness in intergovernmental relations.

By cooperative federalism we mean something quite different from earlier, sanguine conceptions of intergovernmental sharing and partnership.¹⁵⁹ Nor do we argue that federal governments arrange intergovernmental transfers only when local production generates externalities or when competition favors only a subset of governments. Many have pointed out that federal attempts to coordinate the activities of sub-units are often inefficient and fall short of achieving their stated goals.¹⁶⁰ Such attempts may not even be directly aimed at internalizing externalities or stabilizing competition. Canadian intergovernmental transfers and re-

¹⁵⁶ See *id.*

¹⁵⁷ See *infra* Part IV.

¹⁵⁸ See *supra* note 25 and accompanying text.

¹⁵⁹ See, e.g., Daniel J. Elazar, *Federal-State Collaboration in the Nineteenth Century United States*, in *Cooperation and Conflict: Readings in American Federalism* 83 (Daniel J. Elazar et al. eds., 1969).

¹⁶⁰ See, e.g., Richard L. Revesz, *Federalism and Interstate Environmental Externalities*, 144 U. Pa. L. Rev. 2341 (1996) (commenting on American environmental policy); Fritz W. Scharpf, *The Joint-Decision Trap: Lessons from German Federalism and European Integration*, 66 *Pub. Admin.* 239, 247-48 (1988) (discussing joint policy-making in Germany); Scharpf, Reissert & Schnabel, *supra* note 34, at 218-33 (addressing 1969 financial reform in Germany).

gional development initiatives, for example, may actually be more appropriately described as pork-barrel politics than as efficiency-enhancing attempts to stabilize intergovernmental competition.¹⁶¹ Large subsidies to poor provinces like the Maritimes and Quebec are political strategies employed by the central government.¹⁶² In Canada such interjurisdictional redistribution may not only reflect electoral motivations, but in Quebec's case, a strategy for keeping the federation from falling apart. These policies effectively prop up regions that would otherwise be losers in intergovernmental competition.¹⁶³ In the same way, Helmut Kohl won votes and made unification possible in Germany by providing massive subsidies to the eastern Länder in an attempt to make them artificially competitive.¹⁶⁴

In short, a strong federal government capable of regulation and redistribution can be a dominant political strategy. As in the New Deal case described above,¹⁶⁵ national political entrepreneurs in federal democracies are likely to win votes by taking up the cause of the perceived losers in intergovernmental competition. These perceived losers either can be groups of citizens with relatively high moving costs, whose political clout is stronger at the national level than at the state and local level, or they can be citizens of jurisdictions that do not have the resources to compete effectively in interjurisdictional competition. If unregulated competition leads to outcomes that are unsatisfactory to important groups that can be mobilized at the federal level, political entrepreneurs are likely to subsidize them through transfers or other redistributive regulations. According to Bardhan, subordinate groups in

¹⁶¹ See generally Herman Bakvis, *Regional Ministers: Power and Influence in the Canadian Cabinet* (1991) (arguing that ministers in the Canadian Cabinet face strong electoral incentives to funnel public spending to their provinces and especially their own districts). Bakvis finds that spending on so-called regional development projects is particularly prone to this kind of manipulation. *Id.*

¹⁶² See Thomas J. Courchene, *Economic Management and the Division of Powers* 129-51 (1986).

¹⁶³ See Breton, *supra* note 45, at 50-51.

¹⁶⁴ Wolfgang Rensch, *Budgetäre Anpassung statt institutionellen Wandels: Zur finanziellen Bewältigung der Lasten des Beitritts der DDR zur Bundesrepublik Deutschland 1989 bis 1995*, at 47-49 (1995) (unpublished manuscript, on file with the Virginia Law Review Association).

¹⁶⁵ See *supra* note 139 and accompanying text.

India have frequently appealed to supra-local authorities for protection and relief from powerful, wealthy groups in control of low-level state governments: Intervention, even in remote corners of rural India, has often been by invitation.¹⁶⁶

There are numerous reasons why political agents in subnational units might willingly give up autonomy and enter so-called cooperative arrangements administered by the federal government. When large differences in development and wealth separate the jurisdictional units, as in Canada, India, or post-unification Germany, the political agents in some units, such as New Brunswick, Orissa, or Thuringia, may perceive themselves as lacking the resources needed to compete in intergovernmental markets for mobile capital and labor. For them, it is politically rational to give up autonomy and delegate allocational authority to the federal government. In other words, cooperative federalism is not always the outcome of coercive, power-hungry aggression by the central government. Rather, it is sometimes rational for subnational leaders to delegate power to the federal government and tie their own hands. States in federal systems are not like states in the international economy; they can delegate authority to a central government to make and enforce arrangements that stabilize competition and constrain their ability to impose costs on one another. Even wealthy states may favor cooperative solutions when an underlying coordination problem exists. In the United States, for example, state governments favor national standards for some types of environmental regulations.¹⁶⁷

Central governments in decentralized federations face a number of incentives to regulate intergovernmental markets and redistribute wealth between jurisdictions in ways that violate almost all of the requirements for market-preserving federalism. The MPF model does not explain how an ideal market-preserving federal government would avoid responding to these incentives. Even if it is possible to constrain the central government, we question the ability of the central government in an ideal MPF to hold a diverse federation together without the ability to redistribute resources. If jurisdictional units are able to impose costs

¹⁶⁶ Bardhan, *supra* note 10, at 26.

¹⁶⁷ See Mashaw & Rose-Ackerman, *supra* note 56, at 125.

on one another and generate regional inequalities as a result of interjurisdictional competition, it is difficult to imagine that a common market could be sustained.

C. Public Goods

Following the normative fiscal federalism literature,¹⁶⁸ Montinola, Qian, and Weingast argue that the federal government should provide national public goods that would be underprovided by competitive sub-units.¹⁶⁹ Their sole example is monetary policy.¹⁷⁰ Other than that, they do not specify which public goods should be considered national, and which can be provided efficiently by the sub-units.¹⁷¹ In general, the challenge of providing public goods in developing societies receives little attention in the MPF model, which considers the primary challenge of development to be the establishment of credible commitments. To the extent that public goods are addressed, Montinola, Qian, and Weingast imply that most key public goods in an MPF will be provided by the competitive sub-units as they attempt to attract mobile capital.¹⁷² In other words, they envision a very limited role for the central government.¹⁷³

The problem of public goods provision in developing societies does, however, deserve attention. In some developing societies, the state's inability to provide basic infrastructure is a major impediment to development. Due to poorly designed political institutions and the lack of accountability relationships, inefficient or corrupt governments simply fail to provide adequate infrastructure such as ports, roads, canals, and irrigation. Students of un-

¹⁶⁸ See Oates, *supra* note 28, at 31-33 (arguing that central governments in federal systems must be responsible for the provision of "truly national public goods").

¹⁶⁹ Montinola, Qian & Weingast, *supra* note 12, at 55.

¹⁷⁰ *Id.*

¹⁷¹ *Id.*

¹⁷² *Id.* at 77.

¹⁷³ Inman and Rubinfeld note that even a strong central government may not be able to provide pure public goods. Robert P. Inman & Daniel L. Rubinfeld, *Rethinking Federalism*, 11 *J. Econ. Persp.* (forthcoming Fall 1997) (manuscript at 32, on file with the Virginia Law Review Association). Its ability to do so depends crucially on the incentive structures facing federal politicians. See *id.* The method of selecting representatives to the central legislature, for instance, may elevate parochial interests above collective interests in efficient public goods provision. *Id.*

derdevelopment in India, for example, note a severe underprovision of basic public goods, due in part to rent-seeking incentives built into the structure of Indian political and bureaucratic institutions.¹⁷⁴ The Indian states are responsible for a number of key public goods including roads, schools, food and water distribution, and the production and distribution of electricity.¹⁷⁵

The failure of the Indian states to provide such goods is illustrated by the electricity sector. The state electricity boards (“SEBs”) are notoriously inefficient, and insufficient power production has been a major problem throughout India. Supply runs short of demand by up to thirty percent during peak periods, and brown-outs are common.¹⁷⁶ In general, the financial health of the SEBs is in serious question.¹⁷⁷ In addition, the SEBs are often accused of pandering to the political constituencies of their states by providing heavy subsidies through tariffs, particularly for farmers.¹⁷⁸

The general problem of public goods provision in India is undoubtedly complex, but whatever the proposed solution, MPF-style decentralization could aggravate the problem. Contrary to the predictions of MPF, competition between states over mobile resources may not give state-level leaders incentives to provide public infrastructure. State-level leaders need a good deal of revenue to build ports, railroads, and technology centers; raising funds for such projects, especially in resource-poor provinces, would be very difficult politically. Instead of engaging in the sacrifice and long-term planning necessary to entice mobile capital with modern infrastructure, it is much easier to attract investment by offering private benefits, like tax breaks and subsidies, to selected groups of constituents. If this were to become a common practice, firms that are already located in the jurisdictional unit could issue exit threats and try to extract rents for themselves. Because of the political accountability relationships de-

¹⁷⁴ See Bardhan, *Political Economy*, supra note 78, at 60-74; Robert Wade, *The Market*, supra note 72, at 485-86.

¹⁷⁵ See Cashin & Sahay, supra note 129, at 127 n.5.

¹⁷⁶ Sarkar, supra note 94.

¹⁷⁷ India/Utilities: SEB's Continue to Spiral, *Power Asia*, Mar. 18, 1996, available in LEXIS, Asiapc Library, Pasia File. The central government predicts that the commercial losses of the SEBs will increase next year by about 25%, to about \$2.85 billion from the \$2.08 billion estimated for the year ending March 1997. *Id.*

¹⁷⁸ Indian Minister, supra note 88.

scribed above,¹⁷⁹ competition over mobile capital is not likely to be so intense that tax rates on capital are bid down to zero, but it is easy to see that politicians at the subnational level may be tempted to prevent exit by making rent-producing or even corrupt deals with mobile firms. Given MPF's hard budget constraints and impotent central government, this kind of competition could direct money away from the provision of infrastructure.

D. Summary

The market-preserving federalism model, like other models of competitive federalism, attempts to provide the framework for a political system that approaches the optimality of the private market. Weingast and his co-authors argue that if subnational governments in developing countries compete in intergovernmental markets for mobile sources of revenue, they will be constrained by the discipline of competition and refrain from a variety of inefficient activities that stand in the way of economic development and growth.¹⁸⁰ Above all, Weingast maintains, competing jurisdictions will refrain from excessive confiscation, a policy which gives investors confidence that commitments to markets are credible.¹⁸¹ Thus, Weingast argues that the proper political foundation for the market can be established by the introduction of *intergovernmental* markets.

While we do not question Weingast's focus on the political foundations of markets, we argue that in order to make progress, the theory of market-preserving federalism must change its approach to the issue: It must *specify* the political foundations of the intergovernmental market. The simple introduction of market-like mechanisms into a political system will not eliminate problems of political choice. When political goals and institutions are taken seriously, intergovernmental competition may not force subnational politicians to make efficient policies, and in fact the decentralization of authority that is necessary to bring about competition may introduce significant costs.

¹⁷⁹ See *supra* Sections II.A-B.

¹⁸⁰ See *supra* Part I.

¹⁸¹ *Id.*

As the examples in the preceding discussion suggest, the MPF model assumes away some of these decentralization costs. Horizontal cooperation among the subunits in a decentralized federation is not likely to solve the problems of local protectionism, cost exportation, increasing inequality, and public goods. If the central government is not capable of addressing these problems, a number of barriers to efficiency, growth and development will plague the system. A central government that cannot enforce a common market, redistribute resources, or provide public goods may not be able to survive or hold the federation together. The central government will face significant political pressure to solve these problems, but if it is capable of solving them, it is unlikely to retain the most important characteristics of an MPF.¹⁸²

In order to provide a useful guide for the developing world, MPF must bring politics into the model and lay out the institutional foundations for the intergovernmental market. The model seems to imply that the central government should play an important role in facilitating free intergovernmental competition and trade and in providing certain national-level public goods. Presumably the central government must also establish and enforce basic laws. It must be an impartial referee and policeman in certain policy areas without gaining general police power. In short, MPF requires a central government that is strong but limited. As it stands, MPF only restates and elaborates on the fundamental political dilemma at the heart of Weingast's work without providing an adequate solution.¹⁸³

¹⁸² The recent difficulties experienced by the Russian federation further demonstrate the difficulty of simultaneously fulfilling all of the criteria for MPF. See Leonid Polishchuk, *Russian Federalism: Economic Reform and Political Behavior* (Cal. Inst. of Technology Social Science Working Paper No. 972, 1996). Decentralization in Russia has provided regional leaders with incentives to segment the national market by setting up trade barriers, which the federal government has been unable to remove. See *id.* at 22. At the same time, it is difficult for the federal government to resist the demands of aggressive regional authorities for large ad hoc fiscal concessions, which divert resources away from the provision of badly needed national public goods. See *id.* at 20. "The resulting model of federalism is, quite obviously, market-contravening, rather than market-preserving." *Id.* at 22.

¹⁸³ The recent work of Inman and Rubinfeld addresses some important supply-side concerns that must be taken up by federalism theorists. For instance, they show that the structure of the central legislature has important consequences for the functioning of the federal system. See Inman & Rubinfeld, *supra* note 50, at 86-92; Inman & Rubin-

Peter Ordeshook makes an important observation: “[I]t is impossible to predict market outcomes without also predicting the political responses that alternative outcomes engender.”¹⁸⁴ MPF sets up an intergovernmental market and predicts that competition will lead to efficient outcomes but does not consider the likely political responses to MPF institutions. After considering some of those responses, we conclude that intergovernmental competition may not lead to efficient outcomes, and political responses may threaten the stability of decentralized federal equilibria.

IV. THE NORMATIVE IMPLICATIONS OF MARKET-PRESERVING FEDERALISM

In the ideal market-preserving federal system, competition leads to efficiency, low levels of corruption, secure markets, investment, and growth. Citizens choose jurisdictions based on tax-spending combinations, and the problem of preference revelation is solved by the choices of migrants. In response, we have argued that any attempt to emulate the market-preserving ideal is likely to fall short, and we have pointed out some of the deficiencies that would characterize an imperfect MPF. In this second-best world, all good things may not go together. Furthermore, even if a perfectly efficient and stable MPF could be constructed, it would have disturbing normative implications.

An explicit goal of the MPF ideal is to prevent government from being able to respond to the demands of inefficient “distributional coalitions.”¹⁸⁵ We argued above¹⁸⁶ that because of political goals and institutions, exit threats may not be as powerful as Weingast and his co-authors suggest. Even if MPF could be institutionalized and exit threats constrained subnational leaders, the distributive implications would be troublesome. A well-functioning MPF would be incapable of redistributing wealth, and as

feld, *supra* note 173, at 15-20; Robert P. Inman & Daniel L. Rubinfeld, *Making Sense of the Antitrust State-Action Doctrine: Balancing Political Participation and Economic Efficiency in Regulatory Federalism*, 75 *Tex. L. Rev.* 1203, 1225-31 (1997).

¹⁸⁴ Peter C. Ordeshook, *The Emerging Discipline of Political Economy*, in *Perspectives on Positive Political Economy* 9, 9 (James E. Alt & Kenneth A. Shepsle eds., 1990).

¹⁸⁵ See Olson, *supra* note 53, at 43-47 (discussing the problem of “distributional coalitions”).

¹⁸⁶ See *supra* Part III.

explained above,¹⁸⁷ competition in an MPF could lead to increasing levels of regional inequality. Montinola, Qian, and Weingast express optimism that leaders of less competitive jurisdictions will learn from the example of those that succeed,¹⁸⁸ but in the absence of a redistributive central government or a reliable tax base, poor jurisdictions will be at a serious competitive disadvantage.

Not only would a well-functioning MPF be likely to exaggerate regional disparities, but it would increase overall levels of inequality. This is a general normative problem with models of competitive governments in the Tiebout tradition. As one of us has observed before: "A multiple government system is simply not well suited to carrying out distributive goals. It permits wealthy people to cluster together and avoid paying taxes that provide benefits to low-income people."¹⁸⁹ While most students of federalism favor placing redistributive programs at higher levels of government,¹⁹⁰ the MPF model seeks to make this impossible. By glossing over the differences in moving costs and opportunities facing wealthy capital-owners and poor laborers,¹⁹¹ Weingast and his co-authors downplay the possibility that MPF will favor the demands of wealthy, productive, and mobile capital owners at the expense of the poor.

It is at least plausible, as Weingast predicts, that the problems of inequality associated with MPF would eventually be offset by rising overall growth rates resulting from the investment and entrepreneurial activity unleashed by new, more credible commitments to markets. Recent research, however, casts doubt upon the compatibility of high levels of inequality and successful economic development.¹⁹² Negative relationships between inequality and growth have been found by Persson and Tabellini,¹⁹³ Alesina

¹⁸⁷ See *supra* Section III.B.

¹⁸⁸ Montinola, Qian & Weingast, *supra* note 12, at 73-76.

¹⁸⁹ Rose-Ackerman, *supra* note 50, at 37.

¹⁹⁰ See, e.g., Oates, *supra* note 28, at 81; Peterson, *Federalism*, *supra* note 153, at 83-84.

¹⁹¹ For an overview of these issues, see Rose-Ackerman, *supra* note 50, at 36-38.

¹⁹² See Dani Rodrik, *King Kong Meets Godzilla: The World Bank and the East Asian Miracle* (Ctr. for Econ. Policy Research Discussion Paper No. 944, 1994).

¹⁹³ Torsten Persson & Guido Tabellini, *Growth, Distribution, and Politics*, 36 *Eur. Econ. Rev.* 593 (1992).

and Rodrik,¹⁹⁴ and Knack and Keefer.¹⁹⁵ The causal mechanism remains unclear, but a number of plausible explanations have been proposed. Murphy, Shleifer, and Vishny argue that a relatively equal distribution of income can facilitate development because the middle class is a natural source of demand for manufactured goods.¹⁹⁶ Alesina and Rodrik suggest that large inequalities lead to destabilizing political pressure favoring redistribution.¹⁹⁷ Alesina and Perotti argue that such pressure can translate into political instability, which ultimately reduces investment.¹⁹⁸ Knack and Keefer make a similar argument, and find that the impact of inequality on growth does not differ significantly by regime type.¹⁹⁹ It follows that if MPF-style decentralized institutions were introduced in societies, like India or Brazil, that are already characterized by high levels of regional and overall inequality, the exacerbation of tensions associated with the unequal distribution of wealth might serve to undermine the attractiveness of these countries to investors.²⁰⁰ This problem could be particularly acute in India, where distributive issues can easily be magnified by ethnic, linguistic, and caste divisions.

Even if high levels of inequality are not harmful for growth, an MPF is not attractive for low-income citizens or those who reside in poor jurisdictions. An advocate of MPF would probably not dispute the claim that MPF is, after all, an attempt to lay out the political foundations of growth, not fairness or equality. The model conveys the message that the best way to encourage investment and growth is credibly to restrain the government from regulating the economy and redistributing resources. The

¹⁹⁴ Alberto Alesina & Dani Rodrick, *Distributive Politics and Economic Growth*, 109 Q.J. Econ. 465 (1994).

¹⁹⁵ Stephen Knack & Philip Keefer, *Does Inequality Harm Growth Only in Democracies? A Replication and Extension*, 41 Am. J. Pol. Sci. 323 (1997).

¹⁹⁶ See Kevin M. Murphy, Andrei Shleifer & Robert Vishny, *Income Distribution, Market Size, and Industrialization*, 104 Q.J. Econ. 537, 554-559 (1989).

¹⁹⁷ Alesina & Rodrik, *supra* note 194, at 484.

¹⁹⁸ Alberto Alesina & Roberto Perotti, *Income Distribution, Political Instability, and Investment* (Nat'l Bureau of Econ. Research Working Paper No. 4486, 1993).

¹⁹⁹ Knack & Keefer, *supra* note 195.

²⁰⁰ Polishchuk suggests that regional inequalities in Russia leave "a majority of the nation economically disenfranchised," and as a result, Russia's decentralized system is characterized by instability and the counterproductive use of discretion by regional authorities. Polishchuk, *supra* note 182, at 22.

MPF model assumes a rentier or predatory state—a Leviathan that must be constrained from expropriating excess value from citizens and firms. The problem of economic development is presented only as a matter of constraining this Leviathan, and MPF attempts to explain how this can be achieved through decentralized federal institutions. Instead of dealing with both sides of the fundamental political dilemma of building a capable but limited state, Weingast's model is, in fact, mainly concerned with limiting it. For this reason, problems like interstate coordination dilemmas, redistribution, and public goods receive little attention, and the potential role of the state in combating inequality is not considered.

The unequal distributive outcomes produced by the MPF model can be traced to these underlying assumptions. Any attempt by the state to combat inequality would likely be seen as inconsistent with credible commitments to markets and growth. This starting assumption forecloses a range of possibilities. However, there need not be a trade-off between the pursuits of equality and efficiency. According to Bardhan, the terms and conditions of contracts “depend on who owns what and who is empowered to make which decisions.”²⁰¹ Sharp economic divisions can prevent a society from finding institutional structures and opportunities for cooperative problem-solving. If the disenfranchised majority in a developing country is excluded from capital and land markets, a large source of potential productive investment, innovation, and human resource development goes untapped. Under these circumstances, argues Bardhan, if the state carries out redistributive reform:

[S]ome of it may go toward increasing productivity, enhancing credibility of commitments and creating socially more efficient property rights. Even the accountability mechanisms for checking state abuse of power at the local level work better when the poor have more of a stake in the asset base of the local economy.²⁰²

²⁰¹ Bardhan, *supra* note 10, at 27; see also Jack Knight, *Institutions and Social Conflict* 40-47 (1992) (discussing how social institutions affect the distribution of benefits).

²⁰² Bardhan, *supra* note 10, at 27.

The approach to development employed by MPF addresses an important problem in developing societies—the political foundation of markets—but this foundation requires more than the mere incapacitation of the state. As Weingast's fundamental political dilemma implies, states in developing countries must be capable of solving coordination problems and providing public goods. For instance, the state must enforce property rights and basic laws, and it must provide a stable currency, national defense, and infrastructure. Additionally in a decentralized federal system, it must enforce a common market. At one extreme, so-called strong state theorists may overestimate the autonomous capacity of East Asian developmental states and improperly attribute prescience and good intentions to bureaucrats.²⁰³ At the other extreme, the market-preserving federalism framework seems to assume that the state is capable only of theft and mismanagement, and seeks to confound its ability to inflict costly intervention. Both points of view argue that the best institutions are those that insulate the state from the inefficient demands of distribution coalitions. Strong state theorists present a normative argument about what the state *should* do to foster development and explain how to free the state from inefficient interests. The MPF model starts with assumptions about what the state should *not* do, and explains how to prevent inefficient interests from influencing it to do bad things.

Neither approach to state-society relations is adequate. Both try to assume away political goals and institutions. Even if it appears that politicians abdicate to an autonomous and insulated bureaucracy, or that competition over mobile resources places constraints on their behavior, it is misleading to ignore the fact that political leaders must build coalitions of support, both among elites and the masses. Depending on the nature of institutional incentives, they must provide a mixture of patronage, private and

²⁰³ For examples of strong state accounts of rapid economic development in East Asia, see Alice H. Amsden, *Asia's Next Giant: South Korea and Late Industrialization* (1989); Chalmers Johnson, *MITI and the Japanese Miracle: The Growth of Industrial Policy, 1925-1975* (1982); Robert Wade, *Governing the Market: Economic Theory and the Role of Government in East Asian Industrialization* (1990). For a critique of these accounts, see David C. Kang, *South Korean and Taiwanese Development and the New Institutional Economics*, 49 *Int'l Org.* 555 (1995).

public goods, and an assortment of policies aimed at pleasing important constituents. The nature of institutional accountability relationships differs between democratic and authoritarian systems, but in neither case can it be ignored. Rather than using market-like mechanisms to assume away problems of political choice, students of development should explicitly attempt to model such choices. Instead of making welfare-maximizing or rentier assumptions about the state, it is necessary to ask questions about the conditions under which officials have a political interest in providing public versus private goods.

This approach requires the careful study of political institutions to isolate the conditions under which central government officials face incentives to look beyond the demands of special interest lobbies and implement efficient policies favorable to large segments of the population. In order to model a solution to the fundamental political dilemma of an economic system, it is necessary not only to understand the conditions under which politicians are prevented from transgressing markets, but also to know when they face incentives to solidify the foundations for markets. We need to understand when self-interested political leaders will provide electricity, roads, ports, and educational institutions and under what conditions they will support political and legal institutions that provide the stability, predictability, and law enforcement necessary to reduce the uncertainty of market transactions.

With its lack of political foundations, market-preserving federalism leaves too many important questions unanswered to be useful as a prescriptive model for institutional reform in the developing world. It does, however, raise a number of important positive questions that deserve further research. The theory of market-preserving federalism moves institutional economics and developmental studies in a new direction rich with potential. By examining the credibility of commitments made by political leaders in competitive multigovernment systems, Weingast and his collaborators open up a fruitful line of inquiry. The next step in the development of a political economy of federalism is the marriage of demand-side pressures with supply-side constraints. Under certain political and institutional conditions, subnational leaders may respond to efficiency-enhancing demands of mobile factor

owners. Under certain conditions, decentralized federal institutions may indeed provide the framework for a capable but limited state. The next step in the development of a theory of market-preserving federalism must be the specification of these conditions.