COMING TOGETHER: 
THE INDUSTRIAL ORGANIZATION OF FEDERALISM *

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Abstract

In this paper we build upon a burgeoning literature which some have christened as a “second generation economic theory of federalism,” and we attempt to formulate a framework for the comparative analysis of the evolution of different federations. In particular, we study the alternative governance structures that might be chosen to deal with many trade-offs in the design of federal constitutions. We view those governance structures as ways of handling the inevitable incompleteness of intergovernmental contracts. Several other features, not directly related to issues of federalism, complete the “governance” of different countries over time and have a significant impact on the types and characteristics of federal arrangements. Those components of the “broader” governance structure include the structure and characteristics of the Judiciary, the structure and characteristics (formal and informal) of party and electoral organizations, as well as the tendency of formal structures to be superceded by military dictatorships. We argue that these governance structures provide different enforcement technologies for the achievement of complex intertemporal political trades. Hence, they determine the characteristics of federal arrangements at each point in time, by providing the incentive structure for political actors to “invest” in different types of federal institutions. We illustrate our approach with a narrative of the evolution of federalism in Argentina.

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Introduction

The world is undergoing important changes in the configuration of authority across different levels of government. On the one hand, there are processes ("integration") in which certain components of the vector of public policies are moved “up” to some sort of supranational decision mechanisms (i.e. trade policies in North America and the Continent’s Southern Cone or monetary policy in Europe). On the other hand, there are “decentralization” processes in which many government functions are moved “down” to sub-national authorities, closer to the people.

These developments have sparked a new round of academic interest in questions concerning federalism. For example, recent articles in political economy examine how federal institutional arrangements affect political and economic outcomes (Weingast 1995; Qian and Weingast 1997; Inman and Rubinfeld, 1997).

In this paper we attempt to formulate a framework for the comparative analysis of the evolution of different federations, following some of these recent contributions to the economic theory of federalism. In particular, Qian and Weingast (1997) emphasize agency problems between the citizenry (collective principal) and government officials (agents). As a first approximation, in this paper we assume away those considerations and treat “governors” as perfect agents of the citizens in their provinces, while emphasizing incomplete contracting problems among politicians.

The aim of the paper is to develop a framework to study the dynamics of intergovernmental relations. Indeed, we start the description of our framework with a “contractarian” exercise in which independent “provinces” construct a federal governance structure (FGS) in order to achieve some benefits of cooperation. We later claim that the creation of a federal structure to provide the arena for intergovernmental cooperation to occur, can also lead to incentive problems between different levels of government over time. Under certain conditions national and subnational authorities might have incentives and opportunities to cheat on previous arrangements, and circumstantially powerful coalitions might alter the rules of the federal game in their (sometimes short-term) advantage.

Hence, we believe that instead of referring to federalism in generic terms, it is necessary to properly specify which type of federal governance structures are chosen, and how these structures evolve in response to changed technological, economic, political, or even ideological circumstances.

The paper is organized as follows. Section I summarizes some of the recent developments in the economic theory of federalism. In the next section, we analyze the emergence and dynamics of federations using an incomplete-contracts framework. In section III the incentives to invest in efficient institutional arrangements are discussed. Section IV provides some ideas for the comparative analysis of federations. In Section V we illustrate our approach with a narrative of the evolution of federalism in Argentina. Conclusions follow.
I. Recent contributions to the economic theory of federalism.

Federalism has never been easy to define, to understand, or to explain. Take for example the United States, the oldest and one of the most successful experiences in federalism. Its governmental structure has been as much the product of historical circumstances as of institutional design.

Assessing the economic benefits of federalism is even a more difficult task. Traditionally, it has been argued that federalism, the division of sovereign authority among governmental units, allows heterogeneous or geographically dispersed polities to constitute a single and more powerful political economy. In Alexis de Tocqueville’s words, the federal system seeks to combine the different advantages “which result from the magnitude and the littleness of nations” (cited in Oates 1999: 1120).

In this spirit, traditional economic theories of federalism emphasize two sources of benefits. The first one is often associated with the pioneering work of Friedrich Hayek (1945): by tailoring the supply of public goods and services to the particular preferences and circumstances of their constituencies, decentralized provision increases economic welfare above that which results from more centralized mechanisms. The second one is linked to the ideas put forward by Charles Tiebout (1956): if there is mobility within the polity, competition among the sub-national units will allow citizens to sort themselves and match their preferences with a particular supply of local public goods and services.

Building on these arguments, conventional approaches to fiscal federalism (such as Musgrave 1959, Oates 1972) have explored, both in normative and positive terms, which functions and instruments are best centralized and which are best placed in the sphere of decentralized levels of government.

In series of recent articles Barry Weingast and his collaborators have proposed an alternative approach to fiscal federalism related to the “new institutional economics” and the “new theory of the firm” (Weingast 1995; Montinola, Qian and Weingast 1996; Qian and Weingast 1997). According to them, although traditional economic theories study central features of federalism, they do not completely characterize the function and benefits of federalism. In particular, they argue that these approaches “ignore the problem of why government officials have an incentive to behave in the manner prescribed by the theory” (Qian and Weingast 1997: 83).

From this perspective Weingast and its colleagues have explored political decentralization in terms of its capacity to provide a credible commitment to secure economic rights and enhance economic development. This “market-preserving federalism” encompasses a set of conditions governing the allocation of authorities and responsibilities among different levels of government that limit the degree to which a political system can encroach on markets.

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1 These conditions are: (1) The existence of a hierarchy of governments with a delineated scope of authority, such that each government is autonomous within its own sphere of authority; (2) The sub-
Drawing on case studies (including the U.S., England and China), they conclude that “market-preserving federalism’s balance of power between the national and subnational governments is superior to either a complete centralization with a unitary government or a complete decentralization with each region an independent state” (Montinola, Qian and Weingast 1996: 56-57 emphasis added). However, as Rodden and Rose-Ackerman (1997) correctly point out, one should not take this balance of power for granted. For a federal structure to be durable, its constituent units either must have incentives to abide by its rules or must be constrained from changing the rules to their own advantage. As several authors suggest, maintaining a stable equilibrium between the central government and the lower tiers with respect to policy jurisdictions is precisely one of the key problems – if not the central one of federalism. That is, intergovernmental tension is characteristic of decentralized systems of government (Riker, 1964; Bednar, Eskridge and Ferejohn 1997; Bednar 1999).

Moreover, the “centrifugal” and “centripetal” forces that are at work in every federation can even undermine the existence of such federation. The central government might do so by increasing its own power relative to the sub-national units. This was Lord Bryce’s dismal forecast near the end of the 19th century with respect to the U.S. He argued that while the centrifugal forces were likely to prove transitory, “the centripetal forces are permanent and secular forces, working from age to age”. Hence, he concluded, “the importance of the States will decline as the majesty and authority of the National government increase” (cited in Oates 1999: 1145).

On the other hand, federal arrangements might also collapse in the face of centrifugal forces if the constituent units decide that the benefits of membership in the federation are not worth the costs. Hence, as Bednar, Eskridge and Ferejohn point out, the advantages of decentralization of authority will be realizable only if there are good reasons for participants to believe that others will generally abide by its terms (1997: 2). Weingast himself has recognized this. In a more recent article he admits that for market-preserving federalism to work, such arrangement must be sustainable (Qian and Weingast 1997: 89; Parikh and Weingast, 1997: 1613; see also de Figueiredo and Weingast 1997).

Hence, while the ideas presented by this “new economic theory of federalism” are certainly provocative, they raise at least, as may questions as they answer. In particular, it remains unclear (a) how the governmental structure induces non-cooperative behavior on the part of the national and sub-national governments and; (b) how can these forces be restrained from infringing on the federal bargain.

national governments should have primary authority over the economy within their jurisdictions; (3) The national government should have the authority to police the common market and to ensure the mobility of goods and factors across sub-national jurisdictions; (4) Revenue sharing among governments should be limited and borrowing by governments should be constrained so that all governments face hard budget constraints; (5) The allocation of authority and responsibility should have an institutionalized degree of durability, so that it cannot be altered by the national government either unilaterally or under pressures from sub-national governments (Montinola, Qian and Weingast 1996: 54).
II. Federal constitutions as incomplete contracts.

The question to be addressed, thus, is why are intergovernmental relations inherently unstable. In this section we intend to provide an answer to this question following what North (1990) and Dixit (1996) have dubbed a “Transaction-Cost Politics Perspective”, an approach that is very much influenced by advances in the new theory of the firm. In particular, we analyze intergovernmental relations using the analogy of incomplete contracts 2.

The assignment of policy responsibilities between the central government and the lower tiers of a federation is usually formally enshrined in the Constitution. That is, the national and sub-national jurisdictional boundaries are originally established in the constituent rules of a federal polity. However, as Dixit notes, if we view constitutions as contracts, we have to recognize that they are very incomplete ones (1996: 20; Gillette 1997).

Contracts are complete when every provision that is or will be relevant to a transaction can be written down and bargained over by contracting parties. Thus, once the contract is signed, all that remains is a mechanical unfolding of its provisions over time. This means that every possible eventuality is knowable, and so contractual obligations can be made contingent on future events. This is hardly the case of constitutions: they seldom spell out the rules and procedures to be followed in every conceivable instance in precise detail 3.

Unlike, for example business contracts, constitutions, are destined to last for ages. Therefore, they are usually couched in sufficiently general terms, so that they can be interpreted and applied as the polity and the economy changes in ample and unpredictable ways. Note that in this process of interpretation and application there can be large variations in the way a given rule operates. As Dixit points out, an incomplete constitution, thus, “can be manipulated by the participants to serve their own aims” (1996: 20-21).

In the case of federal countries, thus, constitutional conflicts, conflicts over the proper interpretation of the national/sub-national jurisdictional boundaries should be expected to occur. This means that exercises such as those presented above, that is, assessing the “efficiency properties” of federalism is even a much more complex task; for the benefits

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2 We refer here to such literature as Hart and Holmstrom (1987), Milgrom and Roberts (1990), and Williamson (1985). Tirole (1999) provides a very insightful review and critique of the current state of the research on incomplete contracts. See also Epstein and O’Halloran (1997) for an explicitly political application of incomplete contracting.

3 The reasons for this are basically (a) the inability to foresee all the possible contingencies; (b) the complexity of specifying rules, even for the numerous contingencies that can be foreseen; and (c) the difficulty of objectively observing and verifying contingencies so that the specified procedures may be put into action (Dixit 1996: 20).
of adopting a federal structure of government today shall be balanced out with the costs associated with its operation over time.\(^4\)

Therefore, the choice between a unitary or federal governance structure is not such a simple one. Those interested in the design of federal institutions must understand and then balance this potentially important trade-off between the incentives provided at the constitutional stage and those that evolve over time. It seems useful, hence, to analyze the pros and cons of decentralized political structures by distinguishing between the moment of “coming together” and the subsequent evolution of the federation.

**Coming Together.**\(^5\)

Understanding the mix of factors that give rise to a federation is the oldest, and arguably one of the most important questions in the field of federalism. Moreover, virtually all “theories” in the field are, first and foremost, theories of federation emergence. That includes the various perspectives touched on earlier.

In order to conceptualize the emergence of (national) decentralized political structures, one can think of two different stylized starting points. On the one hand, one can think of a formerly centralized structure that is decentralizing or devolving authority to local governments (China, Colombia). On the other hand, federalism might be the result of a process by which a set of formerly independent states or provinces “come together” into a nation (USA, Germany).\(^6\) Although many of the arguments that will be presented below might apply to both stylized origins, our emphasis is more directly relevant for the “coming together” cases (as the narrative of the Argentine case presented in Section V will make clear).\(^7\) Indeed, what follows is a “contractarian” account of how previously sovereign polities might agree to give up part of their sovereignty in order to pool their resources to increase their collective welfare.

Imagine a set of neighboring provinces or sovereign states considering the possibility of undertaking some collective action. What are the benefits of “federalizing” some decisions currently taken in a non-cooperative fashion by each one of them? In the uncoordinated world each polity might be taking some actions—imposing trade taxes, for instance— which might have harmful effects (or under-provided beneficial effects) on other jurisdictions, or there might be economies of scale in the provision of some public goods and services. In a situation like this, thus, there might exist gains from cooperation.

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\(^4\) For a particular application of the incomplete contracts logic to the analysis of federal countries see Gillette (1997).

\(^5\) We are borrowing the expression “coming together” from Stepan (1999).

\(^6\) As it was suggested in the introduction, the logic of this analysis should apply to current integration processes across independent countries as well as to present-day federal countries that were built upon previously independent states.

\(^7\) See Stepan (1999) for an interesting distinction between “coming together” and “holding together” federations.
The question is how can cooperation be achieved. Or, in the “transaction-cost politics” language: how can these polities instrumentalize the welfare-improving political transactions that are missed in autarky? One possibility could be to have decentralized intergovernmental bargains among them. However, this method would only achieve efficient cooperation under very stringent conditions, that is, only if these independent polities operate in a “Coasian” world. But is highly unlikely that this condition will hold. Inman and Rubinfeld (1997: 76-80) and Cooter (1998) provide arguments of why the conditions necessary for the Coasian logic to apply to this “confederate republic as a bargain between city-states” are very unlikely to hold. These conditions are closely related to the inability to write complete contracts discussed above.

Hence, in order to achieve the benefits from cooperation these sovereign polities will need to come up with more heavily “institutionalized” governance structures (a) to credibly enforce the initial agreements and (b) to make choices in the future, when unforeseen contingencies arise.

All of these “institutional” responses imply a certain degree of delegation from the constituent polities to an “agency” -- or more specifically, to a governance structure --, namely a “Federal (or National, or Central) Government.” More specifically, decisions must be made about the proper sphere of central and decentralized jurisdictions, about whether the jurisdiction of central and decentralized governments is exclusive or concurrent, and about potential changes of jurisdictional competence (Gillette, 1997: 1354). Thus, at a minimum such federal governance structure should be composed of:

1. A set \( A \) of policies pertaining to the central government (its jurisdiction)
2. A structure for the federal government (say: a President, a bicameral Congress, a Federal Court; the mechanisms for appointing and removing people to and from these offices, etc.)
3. A process \( V \) by which the provincial governments and the different components of the central government decide (i) changes in \( A \), and (ii) the value of the policy instruments in each component of \( A \).

For simplicity, assume that there cannot be “cooperative” behavior outside this formalized decision making mechanism (i.e., that political transaction costs might be so high that there will be no “voluntary exchanges” that could be enforced). More precisely, assume that those agreements that were feasible in autarky (say, because they were close to spot transactions beneficial to all parties involved, or were sustainable by repeated play without institutional support), will still be feasible, but not others.

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8 We are using “Coasian” here in the same loose way than most of the non-formalized literature does. That is to refer to situations where property rights are well defined and there are no transaction costs (in which case, governance structures do not matter). Coase’s objective was, on the contrary, to point out that governance structures do matter when transaction costs are high.

9 The decisions relating the assignment of \( A \) will tend to require something close to unanimous agreement of the constituent units. In general, the choices within \( A \) will require smaller majorities. These decision rules might, and will probably vary over the set of policies.
Therefore, two very different federal governance structures might arise: one in which, the central government might be very “limited” and another one in which the constituent units might delegate substantial power to the “center”. In the first case, the federal structure would be limited by adopting decision rules that are closer to unanimity of the member states for most issues. However, by doing so, the constituent units might suffer the similar problems than were present in the autarkic situation. They might forego (efficient) transactions conducive to the internalization of externalities (lower barriers to trade) and to the attainment of cooperation to achieve economies of scale (in defense, taxation, pollution control, export promotion) \(^{10}\).

On the other hand, a federal governance structure that delegates substantial power to the center has the potential cost of succumbing to “Bryce’s Law” of federalism. That is, to induce the national forces to opportunistically infringe the federal bargain in the future. We believe that this description might help us to understand what factors are involved in any decision to allocate responsibility within a hierarchy of governmental actors. When choosing a federal governance structure, the constituent units will have to weight the costs and benefits of the different alternatives. And in particular, such costs and benefits will depend in great measure of their expectations with respect to the future evolution of the federation.

We have provided so far a simplified account of the institutional design of federal governance structures at the “coming together” stage. In the remainder of this section we provide a first glimpse into the dynamics of federations and sketch a generalization of the incomplete-contracts logic to issues of constitutional design.

**The Dynamics of Federations**

Having used an incomplete-contracts framework to analyze the emergence of federations, we now turn our attention to the later stages of federalization. What can a perspective stressing the role of institutional incentives and constraints tell us about the dynamics of federations? A great deal we think. Indeed, we believe that there is a lot of continuity between the processes shaping the emergence of a federation and those influencing its ongoing development \(^{11}\).

As it was stated above, when choosing a federal governance structure, the constituent units will try to balance out the threat of centralized exploitation against decentralized opportunistic behavior. The observation that national and sub-national authorities might

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\(^{10}\) One can think of the member countries of Mercosur as being at that stage now. There is a very minimal central governance structure, and they still have difficulties enforcing the effective lowering of barriers to trade.

\(^{11}\) Ideally, one would like to present a formal argument, however, as Bednar (1999) notes, the standard equilibrium analysis modelling form is constrained in its ability to inform us about dynamic development. Hence, we will resort to a discursive analysis, following a heuristics that has become common in dynamic questions of some complexity.
have incentives and opportunities to cheat on previous arrangements (Bednar, Ferejohn and Eskeridge 1997), thus, becomes an interesting evolutionist principle for prediction.

That is, the constitution of the federation might be Pareto improving with respect to autarky, but the arrangement might not evolve through Pareto improving steps afterwards, and could rather become a redistributive mechanism between the national and sub-national governments (and among sub-national units).

Let’s examine this argument in more detail. In particular, the effects of the trade-off between centralization/opportunism on the allocation of authority with respect to changes in the federal governance structure. Recall the three components of a federal governance structure that were defined before. If the second component (the structure of the federal government) is taken as given for a moment, a federal structure can be characterized as a set \( \{A, V\} \), where \( A \) is the policy jurisdiction of the Federal government and \( V \) is the vector of procedures or decision-making rules. Let \( A_i = 1 \) if the particular policy \( A_i \) is in the domain of the federal government (\( A_i = 0 \) otherwise). The different \( V_i \)'s -- i.e, the rules to decide over each type of issue -- will include, thus, unilateral decision by a specified actor (national executive), different majorities in a collective body (Congress), veto power of some actors (national executive, the Courts) over this collective body, etc. More broadly, there might also be rules that require some kinds of national legislation to be ratified by a majority of the states (Gillette, 1997). For simplicity, we can think of those rules as aligned on a one-dimensional scale, where the lower values correspond to extreme delegation to a central agency (the President), while the higher values correspond to larger required majorities.

Let’s reconsider now the constitutional problem of choosing \( \{A, V\} \). Suppose initially that each \((A_i, V_i)\) can be treated in isolation. In this case, finding the optimal governance structure would imply determining each \((A_i, V_i)\). The trade-off in each choice will be similar to the one described above: more centralized mechanisms would be preferred when the issue at hand involves more externalities. But, the potential for opportunistic behavior entailed by each decision rule has to also be taken into account. Therefore, after evaluating each possible decision rule in the light of this trade off, one would come up with an optimized value \((A_i, V_i)^*\).

But the assumption of the previous paragraph is unrealistic. The components of \( \{A, V\} \) are not going to be perfectly separable. Gray areas are bound to appear due to incomplete specification in the original contract. This may be due to unforeseen issues, non-existent at the time of the constitution, such as aviation policy or cyber-law; or to the more “trivial” writing costs of specifying all the characteristics of each possible issue.

\[12\] As a matter of fact, if it were feasible to write, observe, verify and enforce a decision rule for each possible issue it would probably be feasible to specify actions rather than decision rules; i.e. it would be possible to write a complete contract.
This being the case, the possibility of substitution appears: $V_j$ (the rule designed to decide policy $j$) can potentially be used to affect issue $I$, which if foreseen would have been originally assigned, rule $V_i$, different from $V_j$.

One might conjecture that these substitutions would tend to be towards “lighter” decision mechanisms, lower $V_i$’s. Such as the use of an executive decree to decide an issue that should have been decided by a majority in Congress, or the use of simple plurality voting in Congress to pass a bill that should have been approved unanimously.

To see why, suppose that a new issue appears.$^{13}$ Say it is an issue that would have been assigned $V_b$ if it had been contracted initially. Imagine that there are two values of $V_i$ in operation, $V_a$ and $V_c$, with $V_a < V_b < V_c$. Those actors that prefer the issue to be chosen by $V_a$ will have an easier time assembling the necessary majority than those who prefer $V_c$. After that move has taken place, those against it might try to have the decision reversed, probably through judicial means, but there is an inherent bias towards lower $V_i$’s.$^{14}$ Those substitutions will have the effect of increasing the effective policy domain of the more centralized decision-making mechanism, i.e. the policy domain of the central government.

The eventual substitution across rules, thus, drives the potential for opportunism to grow exponentially. Multidimensionality, which complicates the existence of stable equilibria in majority decision making, has the additional effect of enabling this instability to flourish by expanding the possibility of opportunistic behavior. In particular, the growth of the authority set of the central government has the effect of amplifying the space for opportunistic behavior. This is so because it would be easier to find an analogous issue, the more issues are part of the national agenda.

These “substitution effects” will have implications at the constitutional stage and throughout history. The framers of the original contract will react to these substitution possibilities in three margins, relating to the three components of a FGS described above. First, they will give less decision-making authority to the central government (reduce $A$). Second, they will reduce the number of different decision mechanisms $V_i$.$^{15}$ Finally, since there will still be more than one decision making mechanism (and hence the risk of “substitution”), constituent states would like to insure themselves through a coarser mechanism which allows them participation in all national decisions. This leads us to re-examine the component of the FGS we kept momentarily constant: the Federal Government structure. In anticipation of the substitution problem, decision-making rules

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$^{13}$ A new issue needs not be something esoteric as ciber-law. All issues are bundles of characteristics, only some of which are (close to be) perfectly specified in the original constitution. A “new issue” means an issue such that it is not 100% obvious for any impartial observer where exactly does it fit in the partition of the issue space contained in the Constitution.

$^{14}$ Interestingly, this reasoning derives a bias against the status quo, the opposite from the well-known result in Fernández and Rodrik (1991).

$^{15}$ One might try to interpret this result by analogy with the simplification of non-linear pricing schedules when there are possibilities for arbitrage/substitution.
that give the sub-national governments a voice in national policymaking might be adopted.¹⁶

Hence, we might end up with an institutional structure that gives the sub-national units some veto power over national policymaking. This will impose costs on other dimensions, forcing the national government to further substitution and cajoling of provinces to get national legislation through Congress.¹⁷

These substitution tendencies will have implications not only at the initial crafting stage, but also over time. As we describe in the section on Argentina, the dynamic implications of the problem of opportunistic substitutions towards lighter rules will generate successive rounds of tightening, coarsening intergovernmental (in that example, fiscal) arrangements.

### III. Incentives to Invest in More Efficient Institutional Arrangements

To recapitulate, we expect to find, in many federations, decision making rules for several issues that are far from requiring unanimous consent of the constituent provinces.¹⁸ That would be the case as long as (a) there are enough gains from cooperation over a relatively large set of policy issues, (b) that cooperation cannot be achieved by decentralized bargaining, and (c) it is possible to reach an agreement over a governance structure that can limit (at least, to some extent) the costs of opportunism.

Such a structure mitigates the problems of more restrictive governance structures (i.e. Confederations, loose agreements, etc.), in which many efficient political transactions are not realized. But, as in any solution that balances trade-offs, this comes at the cost of creating new problems, opening the door to other forms of opportunism. This section will focus on some inefficiencies that might arise in the dynamics after the original agreement.

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¹⁶ For example, let's say that we were to adopt a collective decision making body (such as the U.S. House of Representatives) with proportional representation and super-majority rule to decide issues which particularly impact upon local interests. If the members of the least populated province fear that once such institutional arrangement is adopted, the substitution effect will lead to the replacement of the super-majority rule by a simple plurality, they will obviously not agree in the first place. Instead, they will probably demand the creation of a second chamber with equal representation for all, such as the U.S. Senate.

¹⁷ In the long run equilibrium, the exact operation of this “federalization of national policies” will depend on the method of electing representatives to the national legislature, of the characteristics of political parties -- whether they develop strong national leadership, or are mostly build from below at the provincial level --, of the attitude of the Supreme Court, etc. Recent Brazilian politics provide sad evidence of the costs of subnational opportunistic behavior towards national policies (see, for instance, Stepan 1999).

¹⁸ In fact, a rule as “simple” as majority in two legislative chambers with presidential veto (and, potentially, Supreme Court veto) is applied in some federal countries (US, Argentina, Brazil) for a very large set of policies.
New institutional choices will have to be made as new situations arise. Those choices will again attempt to balance the trade-offs between efficiency and opportunism, but will do so conditioned on the governance structure inherited from the past. As a result, these choices may fail to achieve the most efficient point in that trade-off. This will be the case because we will be further away from a veil of ignorance, unanimity will no longer be the norm, and circumstantially powerful coalitions will impose their will, sometimes sacrificing some aspects of long-term efficiency in the relevant trade-off. Some actors may want to leave the possibility of future opportunism open, because they see themselves as likely beneficiaries of that situation.

The reaction to this loophole might generate another round of “inefficiencies” in this dynamic framework: some efficient transactions leading to efficient institutional changes may not occur, because of the prospect of expropriation of benefits.

In the economic theory of the firm, if agents anticipate the possible expropriation of part of the returns from an irreversible investment, this will affect the quantity, composition and durability of investment. Some investments are not made at all, others are made in less specific assets or with shorter horizons.\(^{19}\)

Several welfare-improving intergovernmental arrangements have characteristics similar to investments in specific assets: they require undertaking costly and hard to reverse actions with limited to no value in alternative uses, and they produce benefits only in the future. The history of federal fiscal relations in Argentina, that we describe in Saiegh and Tommasi (1999) and that we summarize below, is rich in examples of efficiency-enhancing provincial tax reforms which have such characteristics. Furthermore, even the institutions that rule more broadly the long-term intergovernmental relations (i.e., tax-sharing agreements) have such characteristics.

As long as the future benefits from such “institutional investments” might be affected from opportunistic actions of some of the participants of the game, this extra uncertainty will deter some investments, or will lead them to take less efficient forms. From what we have said heretofore, it should be clear that such potential for opportunism might be abundant in Federal arrangements that try to deal with the inefficiencies of the (originally) decentralized situation.

The magnitude of the potential for opportunism in equilibrium will depend on the overall governance structure at each point in time. On the basis of this analysis, one might postulate an exercise in comparative politics.

\(^{19}\) Furthermore, institutions that would otherwise not arise, emerge for the sole purpose of protecting against opportunism. These include vertical integration in private / private relationships, but also specific contractual guarantees in government / private relations, as well as committee structures in the U.S Congress. We emphasize here the same type of “investment” decision in the context of federal relations; we provide examples in the Argentine case below.
IV. Towards a Comparative Politics of Federalism

As might be clear to the reader by now, the spheres of government authority in federal systems are not unambiguous. Indeed, given the inherent incompleteness of the federal contract, the resulting governance structure usually provides opportunities for either the national or sub-national governments to cheat on the original arrangement. In principle, this account applies to any federal nation. However, in the real world one usually observes substantial differences in structure and in outcomes across countries with federal systems. The obvious question is what factors determine those differences?

According to the argument presented above, the original determinants, such as the externalities involved, and the transaction costs of decentralized bargains, in the original “autarkic” situation will give rise to different governance structures that address differently the described trade-off between centralization and opportunism. Identifying those factors across intergovernmental arrangements might give the observer part of the answer. A second part of the answer involves the development of complementary institutions that “complete” the federal governance structure, and the dynamics of both sets of institutions 20.

Complementary Institutions (Completing the Federal Governance Structure).

Although intergovernmental interaction plays an important role in the choice of the governance structure in federal countries (and is the core of the bargains behind the founding Constitution in many nations), it obviously does not reflect the whole picture. Some parts of the complete governance structure will emerge as a response to other relevant issues. Thus, part of the governance structure that has an impact over intergovernmental outcomes will reflect other objectives, and as such has to be considered to some extent “exogenous”.21

Note however that different configurations in other dimensions can have an important impact on intergovernmental relations. In particular, as Bednar and Eskeridge point out, it necessary to identify what governmental designs or mechanisms might preserve the advantages of federalism as well as ameliorating threats to federal arrangements (1995: 1475).

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20 When we refer here to the “completion” of the governance structure we are making a rather unusual use of the terminology. In standard incomplete-contracts literature, a contract specifies actions under certain conditions, and specifies governance structures to take care of circumstances not explicitly specified in the contract. The standard use starts from a set of actions. In this case, we follow that use only partially. We apply a similar logic over the set of governance structures, and talk about “complementary” governance structures that complete them.

21 The use of “exogenous” in the text is a simplification. It really means interdependent, in the sense that there are things at stake other than federal relations, and these other considerations might lead to a governance structure different from the one that would emerge from optimizing (or compromising) only along the federal dimension.
Commenting on the U.S. case, they suggest different structural features of a political system that might accomplish such goals. For example, they argue that the existence of numerous veto points in the legislative process might help prevent national government aggrandizement (Bednar and Eskeridge 1995: 1477). Another structural feature that helps to preserve a federal system is the existence of a bicameral configuration in which the second chamber represents the sub-national units as such, rather than their population (Bednar and Eskeridge 1995; Linz, 1997; Stepan 1999).

More generally, Bednar, Eskridge and Ferejohn (1997) argue that “horizontal” fragmentation of power at the national level prevents opportunistic behaviors. Such a fragmentation of power, while preventing the formation of a “national” will, constitutes a key to preventing the federal government from predatory jurisdictional expansion. Thus, the extent to which power will be fragmented in a particular country will depend not only on the characteristics of the formal governance structure but also on the nature of its party system. That is, the probability that a central government will pursue a “national” agenda will be contingent on the degree of unification and national orientation of the existing political parties.

However, as Bednar and Eskeridge correctly point out, certain risks do remain against which the political structures will not effectively protect. These problems are associated with sub-national cheating (such as imposing trade barriers, or running budget deficits) and with the aggrandizement of the central government when the national political forces are relatively unified. In these cases, they conclude, the primary and maybe the only self-enforcing structure protecting the federal arrangement is the existence of a Supreme Court. That is, an independent body in charge of adjudicating disputes between the national and sub-national governments and among the latter (1995: 1478).

**Constitutional adjudication and the enforcement of federalism**

Indeed, Bednar and Eskeridge’s conclusion is not surprising at all. Coming back to the discussion presented in section II, given the inherent incompleteness of constitutions, whenever there might be conflicts over the interpretation of its federal provisions, the courts, and ultimately a constitutional court would have to decide those conflicts. The court’s function is to “interpret the Constitution and sometimes ‘to fill holes’ of it, like in the case of conflicts that the Founding Fathers were not able to foresee” (1999: 5).

Hans Kelsen acutely noticed this in his *La garantie juridictionnelle de la Constitution (La Justice constitutionnelle)* of 1928:

«Mais c’est certainment dans l’État fédéral que la justice constitutionnelle acquiert la plus considérable importance. Il n’est pas excessif d’affirmer que l’idée politique de l’État fédéral n’est pleinement réalisée qu’avec l’institution d’un tribunal constitutionnel »

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22 Note that the characteristics of the party system, in turn, will be (at least partially) determined by another component of the governance structure, the electoral rules (i.e. franchise, electoral formulas, district magnitudes, etc.).
Note that in this case what will be important for the preservation of the federal arrangement is not just the presence or absence of a body in charge of constitutional adjudication. If wherever there is federalism there is a constitutional court, then what really matters for the preservation of federalism is the extent to which such a court will be able to make the deal stick. That is, to enforce the national and sub-national jurisdictional boundaries. In their analysis of Canada, Bednar et al. suggest that this country was able to sustain a robust federalism until 1949 – even though it lacked a regime of separate powers – because both national and provincial decisions were reviewed by the Privy Council in London. This body acted as a court of last resort independent of Canadian national or provincial politics. They also argue that after 1949, when Privy Council review ended and the Canadian Supreme Court became the court in charge of constitutional adjudication, effective review of parliamentary statutes in fact ended (Bednar, Eskridge and Ferejohn 1997).

One might conclude, then, that constitutional adjudication certainly plays a critical role to maintain the balance between the different levels of government. However, the extent to which a constitutional court does indeed play such role will depend on its degree of independence from both the national and sub-national powers 23.

Institutional Dynamics

Starting from the global governance structure at each point in time, institutions will adapt to reflect changes in the structural determinants of transactions – a new externality arises, others disappear, technological changes modify the optimal decentralization of some decisions, or an informational barrier that constituted an obstacle to decentralization vanishes. But institutions will also change in response to the interests of political actors that now move in the inherited governance framework (different from the one at the constitutional stage). There will even be new players, such as new politically relevant groups that cut across provinces in a particular way. The dynamics of this process will be heavily dependent upon the possible actions of each player, as defined by the GS. Hence, different initial GS’s can make two systems react differently to the same shock.

Additionally, given that now the game is played under the rules of the inherited GS, with less than unanimity requirements for many decisions, with inter-rule substitution effects, and with complementary institutions that may or may not provide adequate checks and balances, institutions will reflect in turn the impact of opportunism.

Seeing institutions as investments, those investments will in turn reflect expectations about future opportunism. As Moe (1990) suggests, political uncertainty has a profound impact on the choices political actors make once in power. Policies or institutions put in place by powerful policymakers might be subsequently subject to reversal when those actors loose their power. In particular -- as it is analyzed by Besley and Coate (1998) with respect to policies -- political turnover might hinder the implementation of potentially

23 A discussion about the role of the Judiciary in sustaining federalism in the Argentine case can be found in Saiegh (1999).
Pareto-improving public investments. The reason is that policymakers might fear that the policies and institutional structures that they create today will be at the disposal of an opponent’s coalition in the future. Hence, if they want the current decisions to provide benefit flows into the future, they will try to insulate their effects by designing institutions that can survive and prosper in the future. Those actions will tend to create obvious deviations from what would be an optimal institutional design from a purely “technical” point of view.

In terms of the Coase theorem, (political) property rights are, as long as we have something different from unanimity, incompletely defined with regards to the full temporal horizon. If this logic is correct, it can be concluded that the more unstable the economic and political environment, the more incomplete will be the definition of political property rights. Hence, the more political and economic instability, the wider the gap between the policies and institutions that would be chosen from the “economically optimal” ones. This generates a prediction for comparative analysis, which might be applied, for instance, to evaluate the characteristics of different intergovernmental fiscal arrangements.

V. Federalism, Argentine style.

The constitutional structure originally adopted by Argentina in 1853 and its successive modifications has been formally federal. However, many observers have pointed out that in practice, for most of the twentieth century the country had a de jure but not a de facto federalism. This view alleges that the historical evolution of Argentine federalism has been marked by (an almost unilateral) expansion in national authority. Although in principle we agree with this perspective, we prefer to interpret the history in light of the framework presented above, especially regarding our point that the federal government is (at least partially) also an arena for “provincial” decision making.

*The establishment a federal governance structure*

As it was indicated in section II, there might be welfare gains associated with the establishment of a federal governance structure. However, establishing such a structure is a difficult task. In the case of Argentina, throughout the forty years that followed its independence from Spain in 1810, the country was deeply divided over the scope and limits that the federal government should have. A consensus was reached only after several decades of internal wars, the drafting of two failed constitutions and more than twenty years of authoritarian government 24.

In some sense, when a federal constitution was finally adopted in 1860, its main features reflected the aspiration to solve the problems experienced in those decades of political and economic turmoil. First and foremost, the constitution enacted a well-defined

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24 A detailed account of Argentina’s constitutional history from a neo-institutional economics’ approach can be found in Saiegh (1996).
structure of horizontal and vertical accountability modeled after that of the United States. Namely, it provided for a federal system of representative government (CN: art.1) based on a division of power between the central government and the provinces (CN: art. 5), and on the separation of executive, legislative and judicial powers. These were vested, respectively, in a President (CN: art. 74), a Bicameral Congress (CN: art. 36) and a hierarchy of Federal Courts headed by a Supreme Court (CN: art. 94). The three powers were interconnected by a system of checks and balances (CN: arts. 67, 69, 70, 86, 91, 95, 96, 100).

The Constitution also instituted that all the powers that were not explicitly delegated by the provinces to the national government remained in their hands (CN: art.104). On the other hand, it also gave the federal government the power to intervene in the provinces’ territory (CN: art. 6). This, in principle, was meant to be a safeguard against a threat to the republican principles. In fact, the way it was written into the constitution was almost a translation from *Federalist* XLIII: the federal government has power “to guarantee every State in the Union a republican form of government; to protect each of them against invasion; and on application of the legislature, or the executive (when the legislature cannot be convened) against domestic violence”. However, throughout the years its use by the national authorities was going to be a practice that eventually undermined federalism.

With regard to fiscal federalism, the constitution established a division of tax sources. It gave the Federal Government exclusive rights to fix import and export duties and to levy taxes for a specified time “whenever the defense, common safety or general welfare of the State so require”. Provincial governments were explicitly forbidden to impose export and import taxes (art. 4) and special contributions could only be imposed by the National Congress (art. 67).

*The federal practices under the 1860 Constitution*

The scope of action reserved for the central government was originally thought of as very limited. In fact, government in general was conceived as a neutral factor which could not and should not undertake economic and social tasks which, with the exemption of education, could best be left to private initiative and organization (Ferns 1973: 38).

Nonetheless, as soon as national unification was achieved, the federal government started to do more extensive things. When Mitre, the first president elected under the 1860 constitution, came to power, the effort to honor the debts became the chore of the Argentine national government. In October 1862, the federal government took over the debts of the Confederation. These were bonds issued in 1850 and 1860, when the country was not yet reunited (Cortes Conde 1989: 23). A year later, in November 1863, a general law governing public debt was passed. The refinancing of accumulated public debts had a remarkable effect on the value of Argentina’s public debt, enabling the country to secure credit on unprecedented favorable terms. In addition to that, a national currency and a banking system were also considered objects of national necessity (Ferns 1973: 37).
The following years, under the presidencies of Domingo F. Sarmiento, and Nicolas Avellaneda, also saw the establishment of a national legal system, an integrated judicial system, a professional army, a bureaucracy, a national bank, a taxation system, a national treasury, a national customs office, a national voting law, a system of public schooling, public libraries, an academy of science, and other technical institutions.

The use of the federal intervention also reflected this effort by the federal government to constitute a unified Nation-State. The numerous interventions throughout this period were aimed at eliminating potential threats to the federal government by those provinces that still had standing armies or were reluctant to follow the initiatives of the national authorities.

During these years, the Supreme Court also played a critical role in maintaining the balance between the federal government and the provinces. Like the Constitution of the United States, the Argentine Constitution did not establish any norm expressly conferring judicial review power upon the Supreme Court or the other courts. Nonetheless the principles of supremacy of the Constitution (CN: art. 31) and judicial duty when applying the law (CN: art. 100) provided the basis for judicial review (Brewer-Carias 1989). As Eder (1960) points out, from its very inception, in 1863, the federal Supreme Court asserted its right to declare laws unconstitutional.

Indeed, the early rulings by the Supreme Court enforced the constitutional mandates against provincial cheating. In 1869, the Supreme Court protected property rights against an unconstitutional encroachment by a provincial government, declaring unconstitutional a provincial statute, which deprived plaintiff of his property. It also enforced the existence of a common market against provincial regulations burdening inter-provincial commerce (for example, in *Mendoza v. Provincia de San Luis* CSJN 3:131 (1885) regarding inter-provincial trade barriers). Likewise, in 1887 an act of the Federal Congress was held unconstitutional in the *Sojo* case.

It should be noted, though, that in spite of this expansion of the federal government’s regulatory authority, until 1890 the balance of power between the different levels of government was maintained. Basically, this was the result of the restrictive electoral participation at the time. The presidential selection process relied on a system of local party bosses and the seats in the national congress were held by the provincial elites who ruled their communities (Rock 1987). In the case of federal intervention, it was mainly used to maintain the balance of forces between the different factions.

Financially, both the federal government and the provinces had their own sources of revenue. The former raising taxes on foreign trade and the latter raising internal taxes. Since there were almost no transfers across the different levels of government everyone had to adjust their spending to their own budget constraints. However, over time these favorable political and economic conditions for federalism dissipated. During the mid-1880s, many provincial leaders discovered that they could circumvent such budget constraints by resorting to public debt. The provincial banks soon became the chief source of new paper-money issues after 1886, trebling the amount of paper money in
circulation. Moreover, these issues of paper money often exceeded the banks’ gold deposits. Hence, benefiting from the country’s reputation, the provinces turned into heavy gold borrowers abroad. By 1890, the provincial banks and provincial governments were responsible for 35 percent of Argentina’s foreign debt (Rock 1987: 157-158).

This inevitably led to the 1890 crisis. A confidence shock hit the Argentine economy when Baring of London failed to attract subscribers for a loan it had underwritten to reorganize water supply in Buenos Aires. New British investment ceased abruptly and the prices of Argentina’s goods declined. As a result of this, exports’ earnings fell by some 25 percent.

This brought about the first important change in the effective distribution of tax powers. The ordinary resources of the federal government were affected by the balance of payment crisis (custom taxes represented 4/5 of the National government’s revenues), at the same time that the availability of foreign credit was interrupted. In this context, the national government assumed many of the debts the provinces had contracted during the past decade. In return, the provinces were obliged to surrender control over certain local revenues and taxes. President Pellegrini proposed to Congress the imposition of consumption taxes under the guise of “internal taxes” (to distinguish them from custom or “external” taxes) as an emergency measure. The new tax was approved for a year, although the central government was arguing for more time on the basis of Article 4 of the Constitution. It turned out that this “temporary” law was renewed year after year until 1935. More importantly, this marked the beginning of a new relation between the two levels of government with respect to tax revenues.

With respect to this measure, the Supreme Court made a broad interpretation of the Article 4 to validate the tax. According to our view, this ruling was key for the Court to gradually adopt a more generous construction of national authority over taxes in the future. It was also during these years that the Supreme Court in Cullen v. Llerena (1893) ruled that federal interventions where of a “political” nature and could not be contested in Court, leaving more room for the federal intervention in the hands of the federal government.

The 1890 financial crisis also had important political consequences. An organized opposition took arms in July 1890 bringing down the president Miguel Juarez Celman. Although the revolt was put down with the resignation of Juarez Celman, this led to the formation of the Unión Cívica Radical (UCR), a nationally oriented political party.

By 1895 the country resumed its forward march at an accelerated pace. Except for two brief recessions in 1899 and 1907, each of the major sectors of the economy experienced swift, uniform expansion. The GNP increased by roughly 6 percent a year (Rock 1987: 165). As the economy flourished, political unrest abated. However, the opposition forces were still demanding the authorities to open up the electoral system. In 1912, with the Ley Saenz Peña, franchise was widened and the expansion of the electorate finally led to the formation of unified and disciplined political parties. After 1912, the UCR began capturing control of the provinces and increasing its representation in Congress.
When Hipolito Yrigoyen, the leader of the UCR won the presidency in 1916, the system of decentralized authority that had characterized Argentine politics became unglued, and the country entered into a period of increasing centralization of power. In order to carry out his program, Yrigoyen needed control over Congress, so he turned to the device of federal intervention to supplant the conservatives and their party machines in the provinces. During his term there were an unprecedented twenty interventions, fifteen of them by executive decree (Rock 1987: 199).

*The demise of the federal practices of the 1860 Constitution*

On 16 September 1930, in the midst of the international economic crisis, a military coup inaugurated a period of deep political instability. Tenuous semi-democratic and military regimes dominated the political scene for the next 53 years.

During the “provisional” government of 1930-1932, new “national” taxes were created to reduce the dependence on revenue from import duties. On 1 January, the now restored Congress passed a series of laws restructuring the tax system. The Law 12.139 of “Unification of Internal Taxes”, initiated the tax-sharing or “coparticipation” era. The law unified internal taxes, placed their collection under the national government, and established the “coparticipation” of its proceeds by the provinces. As part of the negotiation, the provinces committed to eliminate their own taxes that were similar to those the Nation would now collect.25

As a result of this new institutional framework, the distribution of revenues between the federal government and the provinces, the “primary distribution”, was to be 82.5% for the former and 17.5% for the latter. The distribution among the provinces (“secondary distribution”) was going to be a function of a set of parameters. Given these changes, the share of provincial public spending financed out of national taxation grew by 29 percent in the year 1939.

This tax-sharing agreement, as well as the broader federal fiscal system, proved to be very sensitive to political changes. During military regimes the “vertical” checks on the federal government (mainly the political autonomy of the subnational governments) were greatly diminished.26 The “horizontal” fragmentation of authority at the national level was also lost during military periods.

Moreover, throughout the years, the institutions that were established by civilian governments were subsequently reversed by military regimes and vice-versa. Decision-

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25 This was the first time a special instrument known as Ley Convenio (a law promulgated by the national government and then ratified by the provinces) was used. This ratification mechanism was constructed to avoid hurting the interests of any province. Law 12.139 took into account the taxes previously collected in each province, as well as taxes on economic activities protected by some provinces, like wine, sugar and alcohol production.

26 However, given the previous federal tradition, even under military regimes these “vertical” checks were never reduced to zero. And, in fact, whenever democracy was restored after such regimes, the federal “forces” reappeared with great vigor.
makers, and political actors in general, were continuously changing (Presidents – both de jure and de facto –, provincial governors, Congressmen). With the succession of military regimes, Congress, a natural arena for political bargaining and enforcement, was closed during extended periods of time. Consequently there was not a well-defined locus for negotiating these issues, and a possible arena for the enforcement of intertemporal exchanges, did not become sufficiently institutionalized.

With the rise of a more centralized government, the Supreme Court also came to adopt a jurisprudence that fit this political reality. Furthermore, the judiciary could play a prominent role in enforcing federal expectations only when politically independent. This was apparently not the case. Throughout this era, the Supreme Court Justices were appointed and removed with the different administrations.

The context of political instability, hence, affected also the development of “complementary institutions” that could have allowed intergovernmental transactions with longer horizons. The successive laws and decrees that marked the evolution of the tax-sharing system were oftentimes a way by which the different actors sought to secure short-term gains for themselves. The changes usually involved alterations to the criteria for revenue sharing between the federal government and the provinces as well as among the provinces themselves, and also the development of alternative channels of redistribution through national policies.

When power was more concentrated in the national government (mostly during military regimes), the changes were intended to shift the distribution of shared taxes in its favor. This was achieved by different means: explicitly changing the proportion of tax revenues the national government had to share with the provinces; introducing new taxes not to be shared; or increasing the rates of existing but unshared taxes. Conversely, with democratic opening, the once again elected provincial governors and legislators engaged in new debates over the distribution of tax revenues in order to reverse the changes that were produced during the previous regime. This usually resulted in modifications of the distribution of shared taxes in the provinces’ favor. Along the path, the share of the provincial public spending financed by national resources grew to 47 percent by 1960 and to 62 percent in 1977. Also by about 1977, the redistribution from the more advanced provinces to the less developed ones had also grown considerably.

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27 Between 1930 and 1982 twelve presidents (both de jure and de facto) were taken out of office by force.


29 According to Spiller et al. (1999) since 1946, the average tenure of Supreme Court Justices in Argentina has not exceeded 4 years. In contrast, until that date, the average tenure was 12 years. Also starting in 1946, due to the military interruptions and subsequent redemocratization processes many presidents got to appoint all of the Supreme Court members that held office during his tenure.

30 In 1916 the ratio of public spending per capita between these type of provinces was 2.3, whereas in 1960 was 0.9 and 0.4 in 1977.
Nonetheless, the most powerful tool of the national government throughout this period was inflation: both military and civilian administrations repeatedly used the inflation tax to increase the national treasury’s revenues. The use of such a mechanism also had some deleterious institutional consequences. Inflation had the effect of decreasing the revenue of regular taxes (through the Olivera-Tanzi effect), and required that the National government “shared” seignorage with the provinces. It did so through transfers, mostly in the form of National Treasury Contributions (ATNs), which were allocated discretionally by the federal government. This altered once more federal fiscal relations in Argentina. By 1983, the provincial public sector spending financed by the federal government reached its historical maximum at 72 percent.

With the democratization process initiated in December of 1983, the newly elected governors sought a new co-participation regime. Though negotiations began in 1984, a new accord could not be reached, and the previous regime dating form 1973 expired. Consequently, 1985 was characterized by the absence of a legal regime for “coparticipating” tax revenue between the federal and provincial levels, and all transfers to the provinces were channeled under the form of ATNs. In practice, as Schwartz and Luiksila note, each province “negotiated bilateral agreements with the federal government” (1997: 401).

Finally, in 1987, the provinces and the federal government sought the enactment of a definitive norm. With the new coparticipation law, No 23.548, the provinces’ share of tax revenue reached its historical peak. With respect to the distribution of those funds between provinces, instead of adopting any objective criteria to calculate each province’s share, the law tended to validate the share that each province had obtained in the 1985-1987 period through a coefficient that constituted a “magical number”.

The main features of the 23.548 law prevailed until 1992-93. However, during those years, two successive “fiscal pacts” were also negotiated between the national and sub-national levels of government. In 1993, in an attempt to reform provincial tax systems, the second fiscal pact was signed. Provinces adhering to the pact committed themselves to eliminate local taxes on gross income, stamps, electric utilities, gas and fuel consumption. They also pledged to reduce property taxes, to privatize their companies and to eliminate municipal rates that duplicated provincial taxes. In exchange, the federal government committed to forgive the $900 million debt the provinces had with the Nation and to reduce labor taxes. After a series of negotiations, the federal government also agreed to elevate the guaranteed minimum transfers from $725 million to $740 million. (Several of these promises by national and provincial authorities have not been fulfilled.)

Finally, in 1994 there was a constitutional reform that included important aspects related to the coparticipation scheme. The revised constitution established that a new coparticipation law, based on agreements between the central government and the provinces, had to be drafted before 1996. It also established temporary clauses. First, the

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31 Although the law established this coparticipation regime for 1988, it was extended every year ever since (paradoxically this transitory regime has been the most stable one in years).
distribution of services and functions that at the time of the constitutional reform were performed by the provinces could not be modified without their approval. Second, the effective distribution of resources adopted in the future law could not be less for each province than the amount received at the time the constitutional reform took place.

**D. Some Illustrations of the Theory from the Argentine Case**

Many analysts have pointed out that federal fiscal institutions in Argentina today provide all kind of perverse incentives. In our view, these deficiencies can be explained within the framework presented in this paper: in an environment which has been quite unstable politically and economically (inflation being its most salient expression), political actors tended to adopt a particularly myopic perspective, did not invest in building more efficient institutions, and instead attempted to protect their (quite vulnerable) property rights.

From 1860 to 1890, given that there were not many opportunities for the federal and subnational governments to financially affect each other, the institutional design established in the constitution prevailed. However, in 1890, the federal government’s decision to collect internal taxes (later ratified by the Supreme Court) eventually led to an abrupt change in Argentina’s federal institutional structure. As the federal government’s financial needs grew, its reliance on provincial tax bases rose. Both levels of government collecting taxes over the same taxpayers proved to be an inefficient game.

The establishment of the first Co-participation Law in 1935 was a way out of this inefficiency, implying a major institutional change in both A and V. As a result of the new institutional framework, each province changed its source of revenue, trading the right to collect its own taxes in its territory for a share of total tax collection in the country. Given its potential redistributive properties, the co-participation mechanism was subject to opportunism under the “standard” rules of simple majority with presidential veto. Hence, to effectively reach an agreement, a new decision making mechanism, conceding more veto power to the provinces was also established. This took a special form called Ley Convenio: a law promulgated by the national legislature and then ratified by the provinces.

This institutional structure, thus, was enacted to protect the parties’ property rights. However, the existence of loopholes in the original agreement and of opportunities to change the players’ payoffs with substitutes to coparticipation funds which were allocated with lighter majorities – including unilateral decisions by the national executive - gave place to opportunistic behaviors by different coalitions that violated the original agreement. The result was that property rights ended up being very unstable.

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32 The main problems listed include: the lack of fiscal correspondence, procyclical fiscal behavior, inefficient fiscal mix, redistribution that lacks any rationale, irregular provision of public services, distorting taxes, poor tax compliance, and inadequate risk-sharing. For a detailed account of these problems see Saiegh and Tommasi (1998) and (1999).
The instability of property rights was even more profound given the overall macroeconomic instability that gave the national executive more discretionary power (over the resources to be shared) through the use of the inflation tax. At the same time, political instability affected both “horizontal” and “vertical” checks and balances, minimizing the importance of property rights, and leading to reallocations of resources with long lasting effects.

This instability had effects on the distribution of tax revenue between the federal and subnational governments as well between subnational governments, driving it away from considerations such as equity and efficiency, and making it more susceptible to short term political needs and opportunities. The periodic modifications of the coparticipation scheme led to the current situation in which the whole system has reached a high level of complexity dubbed by many observers as the “fiscal labyrinth” (see Saiegh and Tommasi 1999).

We believe that this history of alteration of property rights over tax revenue, and the logic behind it, can help explain several contemporary features of the Argentine federal fiscal system -- in particular several inefficient outcomes in the macroeconomic and in the public-finance front. The driving force behind those inefficiencies has been the relatively large room for opportunistic behavior, induced by the dynamics that lead to the enlargement of A and to the shortening of horizons.

We can organize the channels leading to these inefficiencies around three theoretical constructs: (1) common-pool problems, (2) efficient political transactions that are not implemented, and (3) safeguards against opportunism that introduce rigidities into intergovernmental finances. All three are the result of the inability of actors to make a commitment.

(1) Common Pool Games

Previous work (Sanguinetti 1994) has asserted that federal fiscal outcomes in Argentina can be explained in terms of a common pool effect. The argument is that the Argentine regime of federal transfers might induce over-spending as each province might try to overuse the national common source of revenue. These game-theoretic results hold depending on the timing of decisions. The federal government is the actor who has the greater incentive to internalize the negative externality of fiscal imprudence. When the federal government is a “second mover,” inefficient results obtain. This modelling assumption reflects the incapacity to commit to a policy collectively decided at the initial stage of the game.

Such inability to commit on the part of the federal government is the result of the chances for opportunism that are given by the governance structure. We argued that the same loopholes that allow opportunistic behavior and expropriation of an investment’s return

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33 Jones, Sanguinetti and Tommasi (1999a) and (1999b) provide empirical evidence that supports this hypothesis.
also destroy possible commitment technologies. In the absence of commitment technologies that provide an obstacle to dynamically inconsistent policies, inefficient choices (such as “bail outs”) might be made.

In the case of Argentina, even though a fixed formula is used to determine the share of revenue between the central and each subnational government, there are possibilities to change the allocation of funds through a series of substitute mechanisms such as geographically located programs or transfers for special purposes. Notice that, while the formula is chosen under something close to federal unanimity, the latter rest in the hands of national Congress and, in some cases, of the national executive. These loopholes lead to an inability to commit and are the source of bad incentives for subnational governments.

(2) Failure to Make Good Institutional Investments

Many of the agreements between governments that could potentially be welfare improving have similar characteristics to investments in specific assets. As long as future benefits might be affected by opportunistic actions of some of the participants of the game, the implied augmented uncertainty deters investment. Two recent Argentine anecdotes serve to illustrate how institutional investments that could lead towards more rational economic policies are not undertaken.

The first example refers to national tax reform. In 1998, at a time of high unemployment, the National government attempted to introduce a tax reform to lower (non-shared) labor taxes, and to replace their revenue by increasing other (shared) taxes. In order to maintain a balance in the federal budget, it was necessary to increase the amount of shared revenues going to the national government. The federal government proposed a complementary “pre-coparticipation” clause for that purpose. The provinces resisted that clause. The resistance was partly due to disagreements about the revenue potential of the increase in the rates of shared taxes that the reform would produce. This highlights the rigidities we want to emphasize, reflecting the incapacity to come up with more complete contracts, contingent on the actual tax collection after the reform.

The second example refers to the attempts at tax decentralization and at substituting inefficient provincial taxes. According to most observers, the most salient defect of the Argentine federal fiscal system is the lack of fiscal correspondence faced by provincial jurisdictions. Scholars and policymakers agree on the need to “decentralize taxes” away from national control, while eliminating several distorting provincial taxes.

The attempts at implementing such decentralization face fierce opposition from most provincial governments -- the opposite from what one might expect, and from what happens in other countries (see Painter 1998 for the Australian case). This attitude, which is perfectly understandable considering prior experiences, reflects the lack of adequate mechanisms to calculate compensations and enforce the deals necessary to instrument such a reform. Every actor fears loosing what it now has in passing to a new system with
uncertain payoffs. There is also an element of “hold-up” in each province refusing to approve a beneficial social change in the hope of receiving an extra payment for its vote.

In the “Fiscal Pacts” of 1992 and 1993 a schedule for the gradual elimination and replacement of the inefficient turnover tax was constructed, but it has not been implemented due to uneven compliance across provinces and to some unfulfilled promises by the Federal Government. The following description of the second Fiscal Pact by Schwartz and Luksila is particularly telling:

“Tax reform was clearly the centerpiece of the second fiscal pact. Provinces adhering to the pact committed themselves to eliminating stamp taxes on checking accounts, taxes on the transfer of fuel, gas and electricity and, most important, phasing out the provincial turnover tax. [....]

Initially, the provinces were slow to join this second pact, largely because of the revenue implications of the tax reforms, particularly the initial stipulation to abolish the provincial turnover tax before June 1995. While the provinces were free to replace the turnover tax with other taxes, many have not yet done so. [....]

Overall, there is no easy short-term alternative for replacing the provincial turnover tax. [....]

Other alternatives for improving provincial revenue would be beneficial in the long run, but would not yield short-term results. [...] Similarly, improving real state taxation would require substantial initial efforts, including, for example, improving property mapping and property registries; providing better and more consistent application of valuation techniques; improving the exchange of information between local tax offices, property registries,.....

The announcement in December 1993 that federal payroll taxes levied on employers would be reduced, depending on region and sector, in those provinces participating in the second pact, increased pressure on provincial governments to join. By May 1994, all but one provincial legislature had ratified the second fiscal pact, and most had taken at least some initial steps toward implementation. Also the provinces were given a minimum revenue guarantee and some other guaranteed fixed payments that provided a floor of federal transfers equivalent to about 4.5% of GDP annually.

The second fiscal pact clearly shows the ‘horse-trading’ that is involved in implementing structural reforms of the system of fiscal federalism. [....], but came at the expense of making payroll taxes an explicit instrument of regional and sectoral policies, and contributed to the growing social security deficit.” (1997: 408-412)

This example illustrates the inability to make intertemporal trades that have the nature of investments, i.e. up-front costs and a later stream of benefits that could be appropriated. It seems that the extant FGS of Argentina cannot support such trades.

(3) Rigidity as Protection from Opportunism

The examples above highlight the difficulties to instrument efficient policies or institutional changes, due to the fear of opportunism. At the same time, political actors have responded to this fear by changing the institutional structure: imposing rigid limits and constraints to prevent opportunism. Some of these measures entailed considerable costs in terms of flexibility and efficiency. Examples: using a fixed formula to determine
the share of tax revenues going to each jurisdiction (instead of making it a function of relevant spending needs); enshrining in the Constitution several mandatory features of the future Tax-Sharing Law (among them, its nature of Ley Convenio); establishing a minimum “floor” of tax revenue for each province.

Conclusions

The aim of this paper was to study intergovernmental relations in federal countries from a transaction-cost politics perspective. Using the logic of incomplete contracts, we described the consequences of this incompleteness for the design of federal governance structures. As part of this analysis we suggested why some particular organizational forms might be chosen instead of others.

We also explored how the features of such governance structures might lead to dynamic incentive problems between the different levels of government, resulting in some undesired and inefficient outcomes. On the one hand, some political transactions that could lead to efficient institutional changes might not take place due to the potential for opportunism by the national and provincial governments. On the other hand, cheating opportunities also undermine commitment technologies that could prevent dynamically inconsistent policies, leading to inefficient policy choices.

The paper also posits that the overall governance structure relevant for the evolution of federalism is composed of the basic constitutional choices plus a set of complementary institutions. Among the latter, we have stressed the structure and characteristics (formal and informal) of the judiciary and of party and electoral organizations. One can postulate a comparative exercise in which the type of “institutional investment” that can be enforced by that overall governance structure explains some features of the performance of different federations.

To illustrate the exercise, we included a study of the Argentine case. We provided an analytic narrative showing how the incentive problems emphasized in the paper lead Argentine political leaders to make non-efficient institutional choices.

Several simplifying assumptions are made in the paper. Not making explicit the interactions of political leaders, especially governors, with their electorates is a simplification we are especially conscious about. In a more general theory of federalism, the evolution of intergovernmental relations ought to be understood as a sequence of adjustments by incumbent politicians who try to cope at the same time with the costs of maintaining the support of the electorate and the costs resulting from the economies of scale / opportunism trade-off this paper deals with. One would expect that both the

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34 The Constitution assigns this law a very special V. The bill should be introduced to Congress “through the Senate and should be approved by a majority of the members of each chamber, cannot be modified unilaterally, nor reglamented and should be ratified by the provinces.” The Senate being the “chamber of origin” means that in case the bill is amended by the other chamber, the Senate can later override those changes.
behavior of governors and the reforms of the federal system are determined not only by the extant federal governance structure but also by the pressures of the political contract with the electorate. This adds some complexity to the problem, but this is perhaps where any group of citizens may distinguish the issue of federalism from the simple constitution of any state.

The theory developed here could be put to use to study the integration processes observed in the world today. It is worth noting that the relatively successful cases, such as the European Union, constitute exceptions from a historical perspective. It might be possible to analyze and interpret the successful and unsuccessful integration experiences in terms of the dynamic problems identified in this paper.

References


