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InterREGIONAL Competition and Federal Cooperation

To compete or to cooperate? That's not the question

Anwar Shah, World Bank

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1. Introduction

Competition among governments at the same level or with similar responsibilities is commonly referred to as the *horizontal competition* or inter-jurisdictional competition in the literature on economics and political science. A related concept of intergovernmental or *vertical competition* refers to competition among governments with different levels and types of responsibilities e.g. among federal, state and local governments. Our concern in this paper is with the inter-jurisdictional competition (interregional or local-local competition) alone and its implications for the federal government's role in securing an economic union or an internal common market.

Competition among state and local governments is quite commonplace in most federal systems. It occurs through lobbying for employment generating and against hazardous waste location of federal or private sector projects including military bases, encouragement of foreign and domestic investment, providing incentives and subsidies for attracting capital and labor, providing public infrastructure to facilitate business location, providing a differentiated menu of local public services, one-stop windows for licensing and registration and endless other ways of demonstrating an open door policy for new capital and skilled workforce. State and local governments also compete among themselves in erecting barriers to trade and tariff walls to protect local industry and business. They also try to out-compete among themselves in exporting tax burdens to non-residents where feasible.

This paper examines the pros and cons of inter-jurisdictional competition in a federal system and examines the ways the federal government can play a supporting role to accentuate the positive aspects of this competition while dealing with any negative fallout of unbridled competition.

2. Inter-jurisdictional Competition and Efficiency in a Federal Economy

Interjurisdictional competition promotes efficiency in a federal economy for several reasons as discussed below:

(i) Matching public services with citizen preferences

In a decentralized federation, independent decision making by state and local governments may enhance efficiency of the federal system. This is because such an uncoordinated decision making promotes competition and innovation in the provision of public services. Citizens are offered a differential menu of tax prices and public services depending upon their location choices. They therefore, have the option of "voting with their feet" to locate in a community that matches public services with their preferences. This voting with feet combined with rational voting behavior creates a private market analogue to public sector decision making where uncoordinated behavior of lower level governments enhances efficiency in a federal economy (see Shah, 1989). Oates and Schwab (1996) for US confirm Stigler's (1957) view that "Competition among communities offers not obstacles but opportunities for various communities to choose the type and scale of government functions they wish" (p.216). According to this so-called 'competitive federalism' (see Breton, 1996) perspective, a greater degree of decentralization and relatively unconstrained policies of local governments makes the public sector more responsive and accountable to its residents. It puts a premium in the efficiency in use of public funds and restrains the size of governments. Mobility of factors restrains the use of distortionary policies by local governments and any costs of uncoordinated decision making will be far outweighed by benefits of inter-jurisdictional competition. This is because intergovernmental competition "impels politicians and public sector bureaucrats to do what is required to make organizational costs as small as possible, or equivalently, to supply goods and services (including redistribution) in the quantities and qualities desired by citizens". (see Breton, 2000, p.1)

Inter-jurisdictional competition to match local public goods with local preferences enhances the functioning of the internal common market. It allows adaptation of labor laws, environmental standards, product safety laws, highway speed limits, use of local languages, protection of local culture, flora and fauna, differential regulatory, procurement and fiscal policies to suit local tastes and preferences. Such differential in policies for local public goods may represent desired departures from uniform practices in the nation and may not circumvent the efficiency considerations provided they use national treatment criterion i.e. they are applied equally to all resident and non-resident persons and entities in the jurisdiction (Boadway and Shah, forthcoming).

(ii) Reinforcing bottom up accountability

Inter-jurisdictional competition encourages governments to compete to retain loyalty of their citizens. This is typically achieved by experimenting and innovating and benchmarking with other governments. These attempts to better serve their citizens by newer services or delivering existing services at higher quality and lower costs is termed as "laboratory federalism" by Wallace Oates (1999). Benchmarking with the best in the business helps citizens evaluate the relative performance of their own government with another better performing jurisdiction. This enables citizens and politicians with important electoral platforms to challenge their governments (see Salmon, 2000). Benchmarking has particularly strong political appeal in metropolitan areas with several competing jurisdictions. It encourages managers to focus on results and in doing so it facilitates private sector participation in the provision of public services. For example, in Malaysia, it is a common practice for most public agencies to make comparisons of their performance in achieving results with similar agencies that perform same functional activity in another jurisdiction or by market counterparts. In Chile and Canada, school financing mechanisms encourage informal benchmarking by private citizens to guide their choice of schools. In Brazil and South Africa, inter-jurisdictional competition leads to improved political competition and greater public participation in decision making at the local levels (see Willis, Garman and Haggard, 1999 and Andrews, 2001).

(iii) Loosening the grip of rent seekers and the corrupt

In developing countries public production processes are often uncompetitive and unaccountable due to the existence of public service monopolies and lack of any competitive pressures. These uncompetitive production processes are usually protected by tariffs, regulatory and information constraints providing opportunities for corruption and self-enrichment to public managers. These situations of unconstrained inefficiency facilitates rent seeking because barriers provide buffers to external scrutiny and because corrupt gains can easily be passed off as waste related to inefficient production methods. These two factors limit the chance of corruption detection and prosecution. Service monopolies have weak incentives to adjust inefficient production processes. Lack of competition due to absence of decentralization leads to entrenchment of inefficiencies and adverse incentives. Horizontal competition by strengthening local autonomy could break this vicious cycle.

(iv) Taming the leviathan

The public sector in some countries is seen by citizens as the “coldest of cold animals, whatever it says it lies and whatever, it has it has stolen” where public managers are focused on rent seeking. In such a setting competition among governments restrains their taxing powers and limits the so-called Leviathan in its ability to extract resources from the private sector. (see Oates, 2001). Under such circumstances, Brennan and Buchanan argue that “.. tax competition among separate units is an objective to be sought in its own right” (1980, p.184). Tax competition among local government in the Punjab province of Pakistan led to tax farming assuring local government stability and growth in local revenues. In South Africa, in Johannesburg metropolitan areas (especially in Sandton and Rosebank), tax rates on businesses increased markedly in early 1990s, this resulted in a tax revolt with many of these businesses relocating to Pretoria, a lower tax jurisdiction 45 miles away.

State and local governments typically have an access to an increasing array of benefit charges. The use of benefit charges as an element of fiscal competition poses no risks for an internal common market. These taxes act as signaling devices for local preferences and increased reliance on them leads to more informed choices on location decisions. Tax competition acts as a useful constraint on policy makers and serves to tame the Leviathan tendencies of such governments. In Switzerland, a highly decentralized multi-ethnic federation, cantons have access to individual income tax, a redistributive tax, as a source of revenue. Kirchgassner and Pommerehne (1996) show that tax competition among cantons did neither impact negatively on public service provision nor compromised redistributive goals.

(v) Improving the quality, quantity and access of local public services

Inter-jurisdictional competition can be a significant source of improvement in service provision in developing countries. In countries where health care and education are decentralized, sub-national governments have an incentive to act competitively. In Latin America significant degree of competition in provision of education services exist leading to differentials in quality and quantity of education services and access. In Ghana some competition is observed at the district level in decentralized health care leading to greater citizen satisfaction and support. In Punjab, Pakistan, several municipalities corporatized public hospitals to improve health service delivery. In the Balochistan province of Pakistan, public school operation and maintenance responsibilities were transferred to community based- organizations (see Bloom, 2000).

3. Inter-jurisdictional Competition as a Source of a "Race to the Bottom" or As An Example of 'Fend For Yourself Federalism'

Unbridled horizontal competition also leads to a number of adverse consequences for a federal economy as discussed below.

(i) Weakening internal common market

Preservation of an internal common market remains an important area of concern to most nations undertaking decentralization. Sub-national governments in their pursuit of attracting labor and capital may indulge in beggar-thy-neighbor policies and in the process may wittingly or unwittingly erect barriers to goods and factor mobility.
A significant body of literature sees such inter-jurisdictional competition as a major source of inefficiency and inequity in a federal economy. This happens when state and local governments use their spending, taxing and regulatory powers to improve local conditions at the expense of non-residents. Examples of such behavior include tariff and non-tariff protection to local industry and businesses, special incentives to attract investment, taxing more heavily goods and services used by non-residents. Differential, standards of services and residency requirements may also impede the free flow of factors across the nation. Tax incentives or differential tax rates may distort firms' location decisions. Differential access to social services limits mobility of individuals. Lack of national minimum standards impedes the flow of goods and services. All these policies wittingly or unwittingly weaken internal common market and economic union.

Inefficiencies from decentralized decision-making can occur in a variety of ways. For one, states may implement policies that discriminate in favor of their own residents and businesses relative to those of other states. They may also engage in beggar-thy-neighbor policies intended to attract economic activity from other states. Ineffciency may also occur due to under-provision of local public services with significant benefit spillouts. Inefficiency may also occur simply from the fact that distortions will arise from different tax structures chosen independently by state governments with no strategic objective in mind. Inefficiencies also can occur if state tax systems adopt different conventions for dealing with businesses (and residents) that operate in more than one jurisdiction at the same time. This can lead to double taxation of some forms of income and non-taxation of others. State tax systems may also introduce inequities as mobility of persons would encourage them to abandon progressivity. Administration costs are also likely to be excessive in an uncoordinated tax system (see Boadway, Roberts and Shah, 2000).

(ii) Degradation of the Quality of Life

The most egregious cases happen when state or local governments in order to attract capital and labor offer an ever expanding array of tax concessions and lowering of environmental and regulatory standards. In offering lower tax rates, they lower the tax burden not just on new capital but also on old capital thereby significantly reducing their revenues and the ability to provide quality services. Alternately they may still provide businesses with quality services but residential services may be curtailed. This behavior resulting in downward spiral in public sector activities is commonly referred to as a “race to the bottom”. Such an extreme situation is unlikely to occur in practice as local residents may not accept such a general degradation of their quality of life. But some less extreme examples of competition are observed every day in all societies, developed and less developed alike. For example, in the USA, location of Toyota Motor Corporation assembly plant attracted a bidding war among several southern states. The Marriott Corporation’s head office is currently located in Maryland yet Marriott frequently threatens to move to Northern Virginia to extract greater tax concessions from Maryland. Ford Motor Company ignited a bidding war among localities and provinces in Canada when it announced its decision to locate an assembly plant in Canada but said it was not sure where to locate it (see Breton, 2000).

(iii) Under-provision of merit goods and social policy fallout

In a federal system, lower level provision of merit goods such as education and health, while desirable for efficiency, preference matching and accountability, can create difficulty in attaining equity objectives in the presence of horizontal competition. Factor mobility and tax competition create strong incentives for state and local governments to under-provide such services and to restrict access to those most in need, such as the poor or the old. This is justified by their greater susceptibility to disease and potentially greater risks for cost curtailment. Such perverse incentives can be eliminated by conditional (conditions on standards of services and access and not on spending or input controls) non-matching grants from federal government. Such grants do not affect local government autonomy and their incentives for cost efficiency but do ensure compliance with federally specified standards for access and level of services (Shah, 1994).

(iv) Expenditure Competition

State or local governments may attempt to attract industry and business using firm specific infrastructure investment or outright subsidies. This is quite a common practice in USA. Procurement and employment policies may discriminate against non-residents as done by the Pakistan provinces. Residency restrictions may be put on use of state or local services such as education as is the common practice by the American states. Boadway and Shah (forthcoming) argue that such measures will distort intenal economic union if they are effective. But if all sub-national governments engage in them, they are likely to be self-defeating and ineffective.

(v) Erecting regulatory impediments

State or local governments sometime erect regulatory impediments for non-residents. These include preferential treatment of local capital and labor; labor market regulations to restrict entry by non-residents ; differential entry requirements for access to training and educational programs and cumbersome re-licensing programs for non-residents; and preferential treatment of local languages.

(vi) *Wasteful tax competition*

State or local governments may inefficiently compete down taxes for fear of loss of tax base. In the end, tax rates on mobile factors may be set inefficiently low due to strategic tax competition. If this practice becomes pervasive then firms faced with competing tax incentives will reap the benefits of such incentives regardless of their location decisions. Thus from local government perspectives these incentives lead to self defeating outcomes i.e. reduced revenues without attracting new capital.

In Brazil, the use of ICMS (origin based) as a tool for attracting capital inflow from other regions has become an area of emerging conflict among states. Despite the fact that the National Council on Fiscal Policy (CONFAZ with state finance ministers as members) sought to harmonize ICMS base and rates, there is evidence that some of the tax concessions refused by the Council are practiced by many states anyway. States can also resort to tax base reductions or grant un-indexed payment deferrals (Longo 1994). For example, some northeastern states have offered fifteen years ICMS tax deferral to industry. In an inflationary environment such a measure can serve as an important inducement for attracting capital from elsewhere in the country (Shah, 1991).

In Pakistan (till 1998) and in India state and local governments imposed taxes on inter-jurisdictional trade to provide protection to local industry and to limit internal trade. In India manufacturing state imposed higher taxation on goods intended for internal trade to pass the tax burden on non-residents. In Brazil, industrial states offered tax deferrals for extended periods on state level VAT. State government in Brazil often indulge in so-called “guerra fiscal” (fiscal wars) by which they strategically attempt to shift local tax burdens to non-residents (see Salomao, 2000). Location specific tax holidays are offered by sub-national governments in a large number of countries. These incentives attract fly-by-night foot loose industries. Sub-national governments in India, Pakistan, Brazil, Malaysia, Mexico, Philippines and others use tax system as an active tool for industrial policy.

(vii) Shifting tax burdens to non-residents

There may be opportunities to export taxes levied on products and services used by non-residents. This is especially the case for taxes on business incomes and natural resources. This practice is quite common in most federations but there are limits to such a strategy due to mobility of factors in the long run and by demand responses.

(viii) Encouraging pork-barrel politics

Another source of wasteful competition in developing countries is the competition among sub-national governments for greater access to higher level financing. Shah (1998) has remarked that due to a lack of focus on service delivery and accountability to own residents, such competition results in sub-national governments competing for scarce public funds to demonstrate ironically that 'money does not buy anything'. In Brazil, the federal and state governments engage in many specific programs or convenios. For many of these programs, program objectives are typically not specified or specified vaguely, and in some instances, grants objectives are determined after the funds are released. In 1989, Brazil had 5000 convenios, out of which nearly 3000 were directed to the home state of President Sarney (Shah, 1991). In Pakistan, in 1995, Prime Minister Bhutto directed all of her discretionary funding to her home distrrct of Larkana in the Sindh province of Pakistan (Shah, 2000). Argentina (Willis, Garman and Haggard, 1999), India, China, Pakistan and Sri Lanka (Shah, 1994) present interesting examples of provincial competition over national level funds. National deficit grants were made available during the 1980s to make up for provincial budgetary shortfalls. This created strong incentives for the provinces to run ever increasing deficits to out-compete other provinces for federal financing. In South Africa, provinces administer de-concentrated national functions such as health and education and are fully financed by the center for the provision of those services. The provinces in the late 1990s strategically overspent on local functions such as stadiums and parks and recreation and then claimed there was not enough monies available to provide nationally mandated services. The national government has been using obtrusive input controls to overcome this problem in recent years and as a result provincial effort has shifted to more intensive lobbying and cultivation of relationship with national politicians and bureaucrats. South Africa offers some additional examples where local governments competed openly and viciously among themselves for seeking financing of pet development projects. Durban and Richards Bay battled over funding sources for building a bulk container terminal. Durban and Cape Town raced to build convention center to attain a competitive edge.

4. Alternative Approaches to Securing An Economic Union

To overcome the undesirable properties of the horizontal competition, various approaches have been followed in federal countries. These include:

(a) *Horizontal coordinating mechanisms*: The Association of Local Governments (most countries), Governors' Conference or the Council of State Finance Ministers (as in

Brazil) or Premiers/First Ministers' Conference (Canada and Australia) do play important roles in devising rules for self discipline to avoid the excesses of non-cooperative behavior while allowing a substantial degree of free play. Bilateral agreements can serve the same purpose but at a higher cost.

(b) *Intergovernmental Bodies*: Institutions of vertical cooperation and coordination such as the Bundesraat, the upper house of Parliament in Germany, and the Loan Council, The Council of Australian Governments and the Premier's Council in Australia and the National Economic Council in Pakistan attempt to achieve a coordinated policy response across all levels of government.

(c) *Role of the Federal Government*: The Federal Governments can also play an important role in securing an economic union. This role as discussed below varies significantly across countries. As we will see in the following, some federal approaches have proved more helpful than others.

(d) *Constitutional Provisions*: Constitutional prohibitions against impediments to free flow of factors and beggar thy neighbor policies can be helpful. This however, brings a strong role for courts to interpret constitutional provisions. Court interventions may prove costly and sometimes not helpful in protecting competitive federalism. The Constitutions of mature federations typically provide: a free trade clause (as in Australia, Canada and Switzerland); federal regulatory power over interstate commerce (as in Australia, Canada, Germany, USA, and Switzerland) and individual mobility rights (as in most federations). In the USA, two constraints imposed by the Constitution on state powers are (see Rafuse, 1991: 3):

The *commerce clause* (article I, & 8): "The Congress shall have power.....To regulate commerce with foreign nations, and among the several states, and with the Indian Tribes."

- - The *due process clause* (amendment XIV, & 1): "No state shall ... deprive any person of life, liberty, or property, without due process of law."

The Indonesian Constitution embodies a free trade and mobility clause. In China, on the other hand, mobility rights of individuals are severely constrained by the operation of "hukou" system of household registration which is used to determine eligibility for grain rations, employment, housing and health care.

5. Approaches to a federal role in securing a common economic union

Federal countries pursue a wide variety of approaches to maintain an internal common market and a sense of nationhood. These approaches can be broadly classified into two categories:

(a) A Partnership Approach or Do No Harm Approach: Federal Government builds a partnership with other levels of government and civil society and uses moral suasion and its powers of the purse to coordinate sub-national policies; and

(b) A Paternalist or a Do Good Approach: Federal Government pursues aggressive policies to bring about internal cohesion.

In the following, we discuss these approaches and their effectiveness in dealing with reducing information and coordination costs and overcoming the dynamic instability associated with non-cooperative competitive behavior at the sub-national level.

(a) Federal Role: A Partnership or Do No Harm Approach

A partnership approach is pursued through a variety of instruments as discussed below:

(i) Preservation of the Internal Common Market

Preservation of an internal common market remains an important area of concern for most nations undertaking decentralization. To deal with sub-national beggar-thy-neighbor policies, in most federations, regulation of economic activity such as trade and investment is generally left to the federal/central government. The Canadian Government in the Ford Motors example cited earlier intervened with provincial governments and was successful in inducing them to avoid a fiscal war to attract the plant. It should be noted, however, that central governments themselves may pursue policies detrimental to the internal common market. Therefore, as suggested by Boadway (1992), constitutional guarantees for free domestic flow of goods and services may be the best alternative to assigning regulatory responsibilities solely to the center.

(ii) Tax Harmonization and Coordination

As noted earlier, tax competition among jurisdictions can be beneficial by encouraging cost-effectiveness and fiscal accountability by state and local governments. It can also by itself lead to a certain amount of tax harmonization. At the same time, decentralized tax policies can cause certain inefficiencies and inequities in a federation as well as lead to excessive administrative costs. Tax harmonization is intended to preserve the best features of tax decentralization while avoiding its disadvantages. Thus tax harmonization and coordination contribute to efficiency of internal common market, reduce collection and compliance costs and help to achieve national standards of equity.

European Union has placed a strong emphasis on tax coordination issues. Canada has used tax collection agreements, tax abatement and tax base sharing to harmonize the tax system. The German federation emphasizes uniformity of tax bases by assigning the tax legislation to the federal government. In developing countries, due to tax centralization, tax coordination issues are relevant only for larger federations such as India and Brazil. In Brazil, CONFAZ (National Council on Fiscal Policy) attempts to keep the base of the ICMS relatively uniform across states. These efforts do not always yield the best results due to the unanimity rule. For example, at the CONFAZ meeting held at Foz do Iguacu on September 25, 1997, a consensus emerged among 26 of the 27 states to exempt capital goods from the state level VAT tax (the ICMS) tax to deal with the inequity that taxes on these goods are levied by the producing states abut tax credits have to be provided by the importing states. This measure however, could not be adopted due the sole opposition from the State of Sao Paulo.

(iii) Intergovernmental Fiscal Transfers

Federal-state transfers in a federal system serve important objectives: alleviating structural imbalances, correcting for fiscal inefficiencies and inequities, providing compensation for benefit spill-outs and achieving fiscal harmonization. These transfers allow the use of the spending power of the federal government to overcome some of the undesirable aspects of fiscal competition. Conditional transfers can serve as an important tool to deal with benefit spill-outs and ensuring national minimum standards to secure common economic union. Equalization transfers similarly overcome the inefficiencies and inequities associated with fiscally induced migration.

Properly structured transfers can enhance competition for the supply of public services, accountability of the fiscal system and fiscal coordination just as general revenue sharing has the potential to undermine it. For example, transfers for basic health and primary education could be made available to both public and not-for-profit private sector on equal basis using as criteria, the demographics of the population served, school age population and student enrollments etc. This would promote competition and innovation as both public and private institutions would compete for public funding. Chile permits Catholic schools access to public education financing. The Canadian provinces allow individual residents to choose among public and private schools for the receipt of their property tax dollars. Such an option has introduced strong incentives for public and private schools to improve their performances and be competitive. Such financing options are especially attractive for providing greater access to public services in rural areas.

(iv) Protecting David from Goliath or Creating A Level Playing Field

Smaller or fiscally disadvantaged jurisdictions may not be able to compete due to having smaller tax base or a jurisdiction not consistent with fully exploiting the economies of scale and scope. It would be appropriate for federal government to assist these jurisdictions. Several options are available to render this assistance: (a) bilateral contracts to provide specified services such as smaller municipalities in Canada purchase policing services from the Royal Canadian Mounted Police in Canada; (b) assuming asymmetric federal role in various sub-national jurisdictions by common agreement; (c) supporting formation of consortium to deal with specific issues. For example, State of Michigan in the USA establishes bond banks to allow access for bond finance to a group of smaller municipalities; and (d) equalization transfers to ensure sub-national governments are able to provide reasonably comparable levels of public services at reasonably comparable burdens of taxation.

(v) Facilitating Local Access to Credit

Facilitating local credit market access can also reduce the need for beggar thy neighbor policies by local governments. Local access to credit requires well functioning financial markets and credit worthy local governments. These pre-requisites are easily met in industrial countries. In spite of this, traditions for assisting local governments by higher level governments are well established in these countries.

In developing countries, undeveloped markets for long term credit and weak municipal creditworthiness limit municipal access to credit. Nevertheless, the predominant central government policy emphasis is on central controls and consequently less attention has been paid to assistance for borrowing. In a few countries such assistance is available through specialized institutions and central guarantees to jump start municipal access to credit. The menu of choices available to local governments for financing capital projects are quite limited and available alternatives are not conducive to developing a sustainable institutional environment for such finance. This is because macroeconomic instability and lack of fiscal discipline and appropriate regulatory regimes has impeded the development of financial and capital markets. In addition, revenue capacity at the local level is limited due to tax centralization. A first transitory step to provide limited credit market access to local governments may be to establish municipal finance corporations run on commercial principles and to encourage the development of municipal rating agencies to assist in such borrowing. Tax decentralization is also important to establish private sector confidence in lending to local governments and sharing in the risks and rewards of such lending.

(vi) Social Risk Management Through Transfer Payments and Social Insurance

Decentralizing transfers to individuals to state and local governments will likely lead to inefficiencies in the internal common market, fiscal inequities and inter-jurisdictional beggar-thy-neighbor policies. Thus the federal government has an important role in unemployment insurance, health insurance, public pensions and other social safety nets.

(vii) Mitigating Adverse Consequences of Globalization

Mitigating adverse consequences of globalization through skill enhancement may also discourage migration in response to fiscal considerations alone and allow disadvantaged regions to compete in the internal market. Globalization of economic activity poses special challenges to fiscal federalism. With globalization, it is increasingly becoming apparent that nation states are too small to tackle large things in life and too large to address small things. In the emerging borderless world economy, interests of residents as citizens are often at odds with their interests as consumers. In securing their interests as consumers in the world economy, individuals are increasingly seeking localization and regionalization of public decision making to better safeguard their interests. With greater mobility of capital, and loosening of regulatory environment for foreign direct investment, local governments as providers of infrastructure related services would serve as more appropriate channels for attracting such investment than national governments. As borders become more porous, cities are expected to replace countries in transnational economic alliances as people across Europe are already discovering that national governments have diminishing relevance in their lives. They are increasingly more inclined to link their identities and allegiances to cities and regions.

With mobility of capital and other inputs, skills rather than resource endowments will determine international competitiveness. Education and training typically however is sub-national government responsibility. Therefore, there would a need to realign this responsibility by giving the national government a greater role in skills enhancement. The new economic environment will also polarize the distribution of income in favor of skilled workers accentuating income inequalities and regional disparities. Since the national governments may not have the means to deal with this social policy fallout, sub-national governments working in tandem with national governments would have to devise strategies in dealing with the emerging crisis in social policy.

In conclusion, federal government by securing economic union through its own policies can help create a level playing field and thereby reduce incentives for state and local governments to follow beggar thy neighbor policies.

(b) Federal Role: A Paternalist Approach or a Do Good Approach

A paternalistic view to deal with horizontal competition and with regional inequity calls for aggressive central government fiscal and regulatory stance to mitigate regional disparities by discouraging out-migration of factors and protection of local industry against competition from the rest of the country. Examples of such policies include regional tax holidays and credits, regionally differentiated social benefits, protection for regional industries, central financing of regional expenditures and direct central government expenditures. Please recall that in the partnership approach discussed earlier, the main thrust of policies was on creating an enabling environment for free mobility, competition and technological diffusion. Here in contrast, the emphasis is on creating protective barriers to nourish "infant" regions and to slow down if not to impede the natural adjustment mechanism. The problem is that such a policy environment may create an incentive structure that could undermine long run growth potential of a region. This dysfunctional result is termed as "transfer dependency" (see Courchene. 1996). Transfer dependency does not refer to overwhelming dependence of constituent units on central government handouts of revenues without accountability - although such a situation may be a contributing factor. Instead, transfer dependency refers to a situation where the central government's regional policies create incentives for individuals and sub-national governments to undertake actions that are not consistent with their long run interest in the absence of such policies. It also creates incentives for residents to stay in the region in view of the regionally differentiated income transfer policies. For example, recipient states/provinces can provide public sector wages that are above their productivity levels. They can run persistent trade deficits with other states but such deficits have little impact on wages and prices within the province as these deficits are typically financed by central government's redistributive policies. As a result, these policies impede market adjustment responses and lead to either maintaining or even worsening of existing income and employment disparities. Transfer dependency is said to exist when the following conditions hold:

(a) regional unemployment rates persistently higher than national average; and
(b) wages are higher than that indicated by labor productivity; and in extreme cases
(c) personal incomes higher than the GDP.

Atlantic Canada, North and Northeast Brazil, Balochistan province of Pakistan and Southern Italy suffer to a varying degree from the ill effects of such a transfer dependency. Thus the overwhelming generosity of the regional policies work to the disadvantage of recipient states and undermine their long run growth potential.

If one examines the country experiences with regional convergence, an obvious conclusion that can be drawn is that whereas the partnership approach has yielded some degree of success, the paternalistic approach has not worked (see Shankar and Shah, 2001). In this context, examples from the U.S. experience are quite instructive. For example, Blanchard and Katz (1992) find that states that experience an adverse shock in demand experience out-migration. The partnership approach to regional disparities undertaken in the USA is highlighted by Lester Throw (1981) in reflecting upon the New England case. Throw argues that New England is prosperous today because it went through a painful transition from old dying industries to new growth industries. According to him, if Washington had protected New England's old dying industries, it may still be a depressed and sick state.

6. Concluding Remarks

Preserving intergovernmental competition and decentralized decision making are important for responsive and accountable governance in federal countries. Beggar thy neighbor policies have the potential to undermine these gains from decentralized decision-making. Short of federal intervention a number of solutions are possible. Competing jurisdictions could reach mutual agreements on the rules of the game and a coordination strategy. They may be high coordination costs for reaching such agreement and developing enforcement mechanisms. In the end such agreements may prove ineffective on issues where stakes may be higher for the competing jurisdictions. Alternately, constitutional prohibitions against local impediments to factor mobility may be helpful. But interpretations of these provisions by the courts may not serve federalism well as these may unduly restrain the powers of sub-national governments.

There is no consensus as to the federal role in preserving horizontal competition while overcoming some negative side effects associated with this competition either. A federal government oversight of horizontal competition may prove too obtrusive to respect local autonomy. Federal role, on the other hand, in using its spending power to secure a common economic union appears promising.

This leads us to conclude that a partnership approach that facilitates an economic union through free mobility of factors by ensuring common minimum standards of public services and dismantling barriers to trade, and wider information and technological access offers the best policy alternative in regional integration and internal cohesion within federal nations. The question is not to compete or to cooperate but how to make sure that all parties compete but do not cheat.

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