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BACKGROUND PAPER

FEDERALISM AND ECONOMIC POLICY-MAKING: ADVANTAGES AND DISADVANTAGES OF THE FEDERAL MODEL

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Federalism, in its modern form, emerged at about the same time as the formulation of the concept of a market economy. One reason for founding a federal union was to create a common market that would permit a free flow of commerce among diverse political communities. By lowering trade barriers between political communities, by mitigating independent and self-aggrandizing economic policy-making within those communities, and by utilizing the resources of the whole country, a common market would foster economic prosperity and national integration. Given that a market needs a governmental framework, even if only a limited one, to maintain the rule of law, protect property, and enforce contracts, constitutional federalism emerged as a way to provide a limited, overarching governmental framework for a common market while still preserving significant powers and functions for the political communities that joined the union. The resulting division and sharing of powers (or competences) between a general union government and the constituent political communities could resolve not only the need to restrain the power of both the union government and the constituent governments for the sake of market freedom but also the cultural and political demands of the constituent political communities for the preservation of their governmental integrity. Such objectives partly motivated the founding of the United States of America in the late eighteenth century, and significantly motivated the founding of the European Union in the late twentieth century.

However, the number and variety of federal systems today, combined with the paucity of comparative empirical research on federalism and economic policy-making, render it impossible to present firm conclusions or confident policy guidance on the advantages and disadvantages of the federal model for economic policy-making and national prosperity. Certainly, the classic federal polity of the modern epoch, the United States of America, has sustained the world's largest and wealthiest economy during much of the twentieth century. Other major federations that have functioned as robust federal and democratic polities--namely, Australia, Austria, Canada, Switzerland, and Germany (since 1949)--also rank among the world's largest and wealthiest economies. Even so, while these cases demonstrate that federalism is compatible with economic prosperity, other cases suggest that federalism, by itself, is neither necessary nor sufficient for economic prosperity, although it is striking that three--Australia, Canada, and the United States--of the world's six territorially largest nations are prosperous federations. The three other territorially huge nations--Brazil, China, and Russia--have not had long-functioning federations and prosperous economies, although Brazil is federal, Russia is constitutionally federal (as it was also during the USSR era), and China has developed some federalist characteristics.

Among the world's less developed countries, such federal nations as Argentina, Brazil, India, Mexico, Nigeria, Pakistan, and Venezuela exhibit a wide range of economic performance. Some of these federal nations have performed better economically than comparable non-federal nations; others have performed less well. However, economic policy-making and performance in many of these federal nations have been affected by the absence of a functioning federal system and even of democracy for long periods of time. Other factors have affected their economic performance, too, including colonial legacies, trade barriers, structural imbalances in the international economy, and anti-market domestic policies. Culture, religion, law, population characteristics, and political party organization also affect economic performance and the quality and implementation of economic policy-making, as well as the operation of a federal system.

Nevertheless, four trends pertinent to federalism and economic policy-making seem to be evident today. First, the value of a market economy has gained nearly universal acceptance, however variable the types of market economies are around the world. A market economy is essentially a non-centralized self-organizing system that produces order out of repeated human interactions within a framework of law. A federal arrangement is also a substantially non-centralized self-organizing system that produces order out of repeated intergovernmental and interjurisdictional interactions within the framework of a constitution or constitutionalized treaties. In this respect, there are important compatibilities between a well-functioning federal system and a well-functioning market economy.

Second, global economic interdependence and integration under free-trade rules are accelerating rapidly, although still unevenly. Consequently, national governments have less autarkic economic policy-making power than they possessed in the past. They must, therefore, increasingly participate in larger international arrangements of local, regional, and global scope in order to establish legal frameworks for the global marketplace and to stem the hemorrhaging of all of their economic policy-making powers. In part, because of this reduction in national autarky, regions and localities within nations (both federal and non-federal) must also increasingly fend for themselves in the highly competitive global economy, thus producing pressures for decentralization and devolution in many nation-states. There is, therefore, the widely observed phenomenon of national governments ceding powers to international and transnational institutions as well as to subnational regions and governments.

Third, citizens worldwide are increasingly demanding access to the goods and services available in the global marketplace. Such access elevates the importance of regional and local governments in economic policy-making because access to the global marketplace depends not only on national rules but also on local and regional infrastructures, such as cable and fiber-optic wiring, reliable and adequate electricity, roads and transport for delivering goods and services, and education. Access to the global marketplace is, in the final analysis, dependent on local capacity. Indeed, the ability of citizens to purchase computers is outpacing the ability of governments to deliver wiring and electricity to their homes and offices. Even in highly developed economies like the United States, there is a "digital divide" between urban and rural areas.

At the same time, access to the global marketplace produces tensions between citizenship and consumership. As consumers, citizens desire unfettered access to the global marketplace, but as citizens, consumers desire local, regional, and national autonomy and self-government. Yet, a robust global economy operating under free-trade rules requires localities, regions, and nations to give up significant degrees of self-governing autonomy. Indeed, now that free-trade rules under the World Trade Organization extend to non-tariff trade barriers, international trade rules will, over the long-term, encroach significantly on the self-governing domestic powers of regional and local governments within federations because those governments ordinarily exercise powers that can be deemed to erect non-tariff trade barriers. Already, for example, the Canadian provinces and U.S. states have battled over brewing, selling, taxing, and regulating beer, and the European Union has targeted some 200 U.S. state laws as violations of free-trade rules. There is, therefore, an inverse relationship between citizenship and consumership: the higher the level of consumership demand, the lower the level of citizenship autonomy; in turn, the higher the level of citizenship autonomy, the lower the level of global economic performance due to the greater number of trade barriers erected by autonomous communities. This is a classic dilemma for federations, now spreading worldwide.

This tension is, perhaps, felt most acutely in the field of culture. There has been growing acceptance of global markets for capital, currency, goods, and most services, but not for culture and language or for human mobility. Given that culture and language are fundamental components of citizenship identity, there has been strong resistance to a free market of culture and language. Instead, citizens, or their nationalist political and intellectual leaders, have often sought to strengthen state powers in order to shield culture and language from the vagaries of market forces and the temptations of the Hollywood culture of the United States. Similarly, there has been little support for a free global market for human beings, namely, unfettered rights of migration and settlement across frontiers. Again, these are classic tensions for federations, which seek to achieve unity with diversity, but the tensions are now both globalized and localized as consumers seek access to the global marketplace and as citizens within nation-states seek autonomy to express their cultural and linguistic nationality locally and globally and also to control the conditions of in-migration. Economic policy-making, therefore, is increasingly infused with cultural, linguistic, and migration considerations within and between nation-states.

Fourth, even though access to, and participation in, the global marketplace occur under non-democratic regimes, long-term pressures for democratization and individual-rights protection appear to be inevitable. Rising business and consumer freedom, or desires for such freedom, generate pressures for citizenship freedom. Here, democratic federations may have distinct economic policy-making advantages. Such federal democracies may be able to adjust to economic change more easily by facilitating rapid and peaceful transfers of power from incompetent or discredited government officials to new officials, as well as transfers of power from less competent or less efficient governments to more competent and more efficient governments. The fluidity of leadership that exists in a democracy and in a non-centralized federal system allows, potentially, for a system of governance that can cope with the fluidity of market forces and human behavior. Democratic governments also provide "voice" mechanisms for citizens, while a federal system provides citizens with opportunities for subnational "exit" and "loyalty" as well. Consequently, a multinational federation compounded of territorially distinct ethnic, racial, tribal, religious, and linguistic political communities can potentially engage in effective economic policy-making under conditions of local, regional, and national democratic citizen-voice coupled with exit and entry rights between jurisdictions within the federation as well as opportunities for compounded local, regional, and national loyalties. In addition, a democracy requires consultation, participation, and bargaining, all of which help policy-makers to forge the political support or consensus needed make effective policy. A federal system imposes additional consultation, participation, and bargaining requirements, especially among multiple elected officials who can represent citizen interests in ways different from the interest groups that function in civil society. Furthermore, a federal system encourages experimentation and innovation. A constituent government can experiment with a new economic policy. If the policy is successful, other governments, including the union government, can adopt it. If the policy is not successful, the federation as a whole is not necessarily damaged by the failure.

In principle, key advantages of a democratic federation also include (1) more efficient provision and production of public services tailored to the diversity of preferences in a federation, including preferences for different modes of service production; (2) better alignment of the costs and benefits of government for a diverse citizenry and, thereby, more equity insofar as citizens get what they pay for and pay for what they get; (3) better fits between public goods and their spatial characteristics, especially the variable economies of scale of different kinds of public goods; (4) increased competition, experimentation, and innovation in the government sector; (5) greater responsiveness to citizen preferences, especially insofar as regional and local governments have the authority and capacity to respond to those preferences; (6) more transparent and close-to-the-citizen accountability in policy-making; and (7) more sensitivity to subnational regional concerns, including the power of constituent governments to provide for their own needs.

The examples of prosperous federations also demonstrate that retentions of significant economic policy-making powers by the constituent governments are not necessarily barriers to common-market prosperity. Although the union government must have vigorous economic policy-making powers with respect to common-market functions (i.e., interstate commerce), the constituent governments need not be denuded of the powers requisite for self-government and economic self-development. Nor is it necessary to coordinate economic policy-making and tax policy from above, or to harmonize all subnational rules and regulations for common-market purposes. Mutual-recognition schemes can perform adequately, and regulatory and economic policy-making competition among the constituent governments can be beneficial rather than always detrimental to the prosperity of a federation.

It must be recognized, however, that economic policy-making and economic performance are shaped by many factors distinctive to various individual federations and to types of federations. One factor, for instance, is that many federations have been formed more for reasons of domestic peace and security than for common-market prosperity. This distinction cannot be drawn too sharply, but when a federation must give priority to domestic peace and security in the face of fragmenting political forces, such as secession movements, obstructive constituent governments, and self-aggrandizing regional politicians, then economic policy-making must necessarily take into account political considerations that may not be compatible with common-market prosperity. Over time, moreover, the locus of power can shift toward the union government, which might stifle market freedom, along with other freedoms and the powers of constituent governments, in efforts to achieve national peace and security. Alternatively, the locus of power can shift toward the constituent governments, which might fragment the common market by erecting trade barriers in efforts to enhance their own autonomy at the expense of the union and of each other.

Similarly, economic policy-making is effected by the degree of integration in a federation. In a highly integrated federation, economic policy-making by the union government and by the constituent governments is likely to be integrative and compatible, if not necessarily coordinated officially, because all governments have a common interest in maintaining a mutually beneficial economic regime. In a less well integrated federation, economic policy-making by the union government and by the constituent governments is more likely to be conflictual and contradictory. To some extent, integration is a chicken-or-egg question for federations. Economic integration requires political integration, but political integration also requires economic integration. Hence, economic policy-making, along with all other policy-making, must strike delicate balances lest the federation disintegrate or consolidate under a monopolistic national government that ceases to be federal.

The development of the European Union (EU) illustrates yet another dimension of integration tension. Some of the leading founders of what has become the European Union believed, or hoped, that economic integration would also produce political integration. Some political integration has necessarily resulted from economic integration, but there has been far more enthusiasm for economic integration in the EU than for political integration, and the long-term success of the EU still seems to be dependent on the union's economic performance, not on its political performance.

Given the extraordinary proliferation during recent decades of national autonomy movements worldwide, the EU might represent a new model of federation able to accommodate those movements, namely, a model characterized by a high level of economic integration and a low level of political integration. The EU is a kind of confederal federal arrangement. It is confederal insofar as its constitution is based on treaties ratified by all of the member states and its most important policy decisions are controlled by the heads of state and government of the member states. But the EU is functionally federal insofar as the member states have delegated far-reaching economic policy-making powers to the EU, including, now, a central bank. Other regional arrangements, such as the North

American Free Trade Agreement (NAFTA), which encompasses three federal polities, also aim to achieve more economic integration through a larger common market, but with little or no political integration.

These regional arrangements, however, depend on an important third factor: regional peace and security. In Western Europe, plagued by two terrible wars during this century, the overarching security umbrella provided by the North Atlantic Treaty Organization (NATO) and supported by the military and economic power of the United States has created the conditions of peace and security needed to forge the European Union and its increasingly integrated common market.. In the case of North America, Canada and the United States have long shared a pacific, unfortified border. Mexico-U.S. relations have been less cordial, but nevertheless militarily peaceful for more than a century. Although, in the final analysis, the United States is the security umbrella for North America, too, the pacific conditions and cooperation needed for economic integration were essentially self-organized by these neighboring federations. It is this peace-and-security factor that can make the world safe for federalism.

These regional arrangements suggest, moreover, that is no longer necessary to think about federalism in traditional, classic terms, such as those associated with American federalism. There is, for example, no self-evident imperative for the European Union to become the United States of Europe. Instead, so long as regional peace and security can be guaranteed by self-organized cooperation, an overarching security league, or a benign superpower, it becomes possible for nations and states to think more broadly about federalism and to develop varieties of federal arrangements, especially arrangements that place more emphasis on economic integration and than on political integration. The need to form a highly politically integrated federal union is less urgent, and ambitious politicians are deprived of a credible rationale for centralizing power.

Given that globalization is also propelling economic integration regardless of the preferences of national governments, varieties of regional and even global governance arrangements of a broadly federal character are gradually, though still unevenly, enveloping the global marketplace as a nascent governmental framework. Consequently, older notions of independent nation-states forming their own autarkic federations as though each were an isolated island are no longer rational or feasible. Instead, varieties of national federalisms are feasible, including significantly autonomous self-governing stateless nations, all nested in sets of larger territorial confederal arrangements and embedded in overlapping functionally federal jurisdictions.

Such emerging complexity makes it all the more difficult to speak of federalism and economic policy-making in any singular, conclusive manner. However, if the foreseeable future takes the form of confederal federalism, then economic integration will continue to precede political integration, regional and global confederal structures will emerge to govern the marketplace in a functionally federal manner, and both nation-states and stateless nations will seek to limit political and cultural integration.

This also means that it is no longer necessary to think of federal arrangements as necessarily symmetrical, that is, where all constituent governments possess equal constitutional powers on an equal footing. The rise of asymmetrical federal arrangements, such as the Spanish state of the autonomies, suggest that it is both possible and, in some cases, necessary to permit variations in the constitutional powers of a federation's constituent governments. This surely complicates economic policy-making, but does not necessarily impede effective economic policy-making. Furthermore, asymmetry is implicitly present in a de facto sense in every federation. Even where states or provinces are constitutionally equal, they are not fiscally equal. Consequently, the union government ordinarily engages in fiscal and economic policy-making intended to enhance the capacities of fiscally weak governments, thereby bringing their de facto capacity more in line with their de jure authority. In addition, the union government may generate mild asymmetries by allowing constituent governments to choose whether to implement union policies themselves or leave it to the union government to do so. Even in the United States, a highly symmetrical federal polity, each state can choose to implement federal policy or its own policy (so long as the policy is equal to or better than the federal policy) in a wide variety of economic and other fields.

Economic policy-making may also be influenced by the process of federal formation. The classic pattern involved independent states or political communities joining together in a federal union. Although the covenanting political communities ordinarily delegate substantial economic policy-making powers, especially common-market powers, to the union government, they also seek to reserve significant economic policy-making powers for themselves. Over the course of the development of the federation, much attention must be given to balancing and coordinating the economic policy-making activities of the union and the constituent governments. In recent decades, however, rising pressures for decentralization and subnational autonomy have produced new patterns of federal formation in which a previously centralized and sometimes authoritarian government devolves powers to regional governments. The economic policy-making consequences and economic effects of such devolutionary federalism remain to be seen. A key tension, though, is between the desire of national officials to hold onto policy-making powers and the desire of new regional officials to capture policy-making powers.

Economic policy-making and performance are also shaped and constrained by fundamental principles underlying a federation. One key distinction is between federations based on liberal individualism and federations based on multiple communal identities, namely, nationality, language, religion, tribe, and/or race. This distinction cannot be drawn sharply in every case, but it has heuristic value. In a federation rooted in liberal individualism, citizens have virtually unfettered rights, as well as opportunities and incentives, to move between jurisdictions and to discipline governments by "voting with their feet" (i.e., the Tiebout effect). Such interjurisdictional mobility has significant consequences for economic policy-making and the development of a common market. Such mobility also generates distinctive patterns of intergovernmental (i.e., federal-regional-local) and interjurisdictional (i.e., interstate and interlocal) collusion, cooperation, competition, and conflict. It is this liberal individualist model of federalism that has dominated the research literature on fiscal and economic federalism because much of this literature originates from the United States, Canada, and Australia.

Most federations and quasi-federations, however, are multinational, and many or most nationality populations are concentrated in separate subnational territories. Even if all individuals in the federation are given an unfettered de jure right to move from one jurisdiction to another, the de facto presence of linguistic, religious, cultural, and other barriers inhibits mobility. Economic policy-making in an immobile federation must ordinarily, therefore, take different forms from economic policy-making in a mobile federation. In particular, economic and fiscal disparities among the constituent governments assume heightened policy importance because the disparities cannot be addressed by converging market forces; instead, they must be addressed through union policies involving fiscal equalization and regional structural development. There is also likely to be a major political dimension to such economic policy-making, namely, that policies to address economic and fiscal disparities are necessary to hold the union together.

A principal problem with fiscal equalization and regional structural policies is that they are highly contentious and frequently inefficient. Wealthy jurisdictions can resent the union government and neighboring jurisdictions for draining their wealth to subsidize others, and virtually no jurisdiction believes that it is paying or receiving its fair share. Regional development policies pursued by the union government often subsidize waste and inefficiency. Such policies also tend to become frozen into the system so that even when disparities converge or a region experiences significant economic growth, it remains politically difficult to re-write grant formulas and to terminate subsidies. In principle, an economically efficient and politically accountable federation is one in which, among other things, every elected official who enjoys the pleasure of spending taxpayers' money must first experience the pain of extracting that money from the taxpayers. In practice, of course, politicians, like all people, are pleasure seekers and pain avoiders.

There are, therefore, no easy remedies for these issues. However, to the extent that the union government can tie regional economic policy-making to regional self-help efforts, inefficiencies can be mitigated to a greater extent. Given the importance of infrastructure for economic development, the union government can make direct provision for key infrastructure facilities and provide specific grants for specific purposes tied to local efforts. It is also important that the union government enact laws and implement policies that allow and encourage its constituent political communities to compete in the global marketplace, attract investment and tourists, and export goods and services. It is equally important that monetary policy, ordinarily managed by a central union bank, be as responsive as possible to the diversity of regional conditions within the federation.

In summary, the diversity of federal arrangements present in today's world precludes broad, confident conclusions about the advantages of federalism for economic policy-making, as well as uniform policy prescriptions for all federations. In turn, the constitutional allocation of powers in federations varies markedly from one federation to another. No single constitutional formula seems best for all federations, although systematic research would likely demonstrate that some types of allocation are more optimal than others. Nevertheless, the remarkable development of many federal arrangements throughout the world, and the growing interest in federalism in recent decades, especially in light of the disenchantment with highly centralized political systems and excessively commanded economies, suggest that federalism, broadly conceived, has become an appealing model for addressing the economic, political, and cultural concerns of the twenty-first century. The proliferation of federal arrangements, moreover, provides us with many models for possible emulation and with many opportunities for dialogue and research among federations.

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