

IMPROVING PERFORMANCE BY POLITICAL
DECENTRALIZATION (OR CENTRALIZATION)?

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by

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Abstract

Changes in political decentralization arrangements may be a way to improve the performance of a country in terms of general economic indicators or in some policy areas. That possibility is generally discussed from a perspective akin to comparative statics. The analysis then focuses on complementarities between characteristics supposed to be a-temporal and it seeks to identify combinations that perform better than others. The paper explains why that perspective may allow contrasting positions with regard to decentralization even among proponents of free and competitive markets (Reaganomics versus Thatcherism). It seems from the literature that no robust and economically significant relation of a general kind between the level or characteristics of political decentralization and economic performance has been found and the situation is not much better in policy areas such as education and health. This does not mean, however, that changes in decentralisation arrangements in a country never aim at – and never succeed in - improving the performance of that country, *given its particulars*. In an interdependent and informationally open world, governments will have an incentive to improve economic and social performance when it is very deficient, and this may explain some of the changes observed in decentralization arrangements, which then, in turn, should have on average a positive effect on performance. The effect could be due to the adoption of a structurally better combination of characteristics or to the virtues of change *per se*.

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I. Introduction

Is there a relation between decentralization or federalist arrangements – what we may call, following Daniel Treisman (2007), the ‘architecture of government’ – and the efficacy of economic governance, in particular when measured in terms of economic growth and development? The case of China comes to mind. An influential view is that the amazing economic performance of that country has much to do with the way it has organized the relations between central and regional and local authorities. The case of China is particularly salient but the relation between a country’s “architecture of government” and its economic performance plays a role in the discussion of the economic situation and prospects of many other countries, especially but not exclusively those which are federations.

In the case of Europe, the question of the relation between the institutional organization of multi-tier governance and the economy is relevant in some countries but its main importance is at the level of the European Union (EU). In the territory that the EU covers, the policy-making capacity of the member states, acting separately, is bounded by the existing rules of the internal market and potentially by the even stricter features that the internal market is officially set to present when “completed”. This is a major aspect of economic governance in each and all of the member countries of the EU, another being the way collective decision-making, at the level of the Union or at that of the Euro zone, is organized.

The view for some time held by many (including within international organizations such as the World Bank) that political decentralization is generally favourable to economic growth and development is not very well supported empirically. This has not discouraged the search for general propositions but it has induced increased attention to underlying interactions and mechanisms that may account for a more complex observable relationship than a simple correlation between, say, a measure of fiscal decentralization and a rate of economic growth. Combinations of institutional characteristics that yield a better economic performance than others have been sought. An illustration is Barry Weingast’s theory of “market-preserving federalism”, to which we shall return.

As is the case in that theory, most analyses have involved assumptions about how governments behave and assumptions about how an economy may grow. Both categories of assumptions tend to make the matter somewhat ideological. It is tempting to derive a positive relation between political decentralization and economic growth from two underlying relations: one between decentralization and the preservation of markets; the other between reliance on markets and faster economic growth. But the matter cannot be so simple. To fight

the Great Depression, the New Deal led to a diminished reliance on markets and an increased centralization of the American governmental system. Conversely, but under the same logic, to preserve or foster markets Ronald Reagan in the United States and the Communist Party in China favoured political decentralization. However, for the same purpose, a different logic apparently led the Conservative government in Britain under Margaret Thatcher and her successor to promote political centralization both in Britain and, ironically, at the level of the European Union. The difference between Reaganomics and Thatcherism on the matter mentioned, involving deep-seated differences in the interpretation of how governments and markets behave, has a general relevance and will be analyzed in relative detail in Section 2.

In that section, as in the foregoing discussion, we remain faithful, in a loose sense, to the way economists traditionally approach the relationship between institutions and the economy. Economists (and many other social science scholars) seek general propositions, derived from or linked with pieces of theoretical reasoning typically set in terms of comparative statics. The approach is particularly visible and fruitful when it leads to the discovery of robust empirical regularities. But it also underlies apparently informal, slightly ideological, discussions such as the ones which were triggered by Weingast's theory already mentioned. And it underlies also the informal discussion about ideologies or views to be presented in Section 2. In that discussion also, the focus is on complementarities between characteristics supposed to be universal and a-temporal. For the question we are concerned with in this paper, we may observe that, in spite of the valuable efforts of many scholars, the approach has yielded few, if any, robust generalizations, and even if the insights it may provide regarding some quasi-ideological positions are hopefully not completely without interest, their significance remains limited.

The problem is that the variables included in general propositions stand in relations of complementarity with many particular characteristics of countries, many of them of a non-economic kind. Does this mean that nothing a little general can be said, and that in each country the idea of some inspiration stemming from the observation or analysis of arrangements adopted abroad is meaningless? A completely different approach may be worth exploring. In it, the idiosyncratic nature of the institutional arrangements in force in any country – or, to account for the EU, group of countries -- is fully acknowledged. Given the importance of the particular characteristics of each country, along many different dimensions (historical, cultural, geographical, and so on), the question of whether the decentralization arrangements in force in it are optimal or not, or have a causal identifiable relation with observable economic performance, is treated as a matter of opinion, judgement or consultancy

-- in any case outside the reach of scientific inquiry proper. However, from the latter perspective, it might be possible to say something about the relation between *changes* in decentralization arrangements and economic performance. We may form the hypothesis that, in an interdependent and informationally open world, governments will have an incentive to improve economic and social performance when it is very deficient, that this incentive may explain some of the changes observed in decentralization arrangements, and that, in turn, these changes should be expected to have, on average, a positive effect on performance. As we will see, the positive effects could be due to the adoption of a supposedly better combination of systemic characteristics or to the virtues of change *per se*.

The first part of this reasoning is based on a view of government behaviour which is developed in Section 3, devoted to democratic or quasi-democratic mechanisms in a context of yardstick competition. The hypothesis we suggest exploring is presented and discussed in Section 4.

II. Preserving markets by decentralization, or by centralization?

General opinions about economic governance involve beliefs or assumptions about the nature of government and about the nature of markets. In this section, we concentrate on the question of how views on political decentralization are often associated with such beliefs or assumptions. We consider only differences within the liberal (*i.e.* pro-market) doctrines. The general idea is illustrated in Table 1. In it, Column 1 represents the idea that governments, if unchecked, are fundamentally predatory or the prey of interest groups, including their own bureaucracies. As a consequence, it is essential to find mechanisms that constrain government. To “tame the Leviathan”, the solution sought relies on mobility-based competition among sub-central governments together with constitutional limits to what they may do (Brennan and Buchanan 1980, Weingast 1993, 1995). The view, more traditional among economists, that governments are instruments which can be dangerous but may also be trusted to perform some indispensable tasks pertaining to economic governance is expressed in Column 2. Line 1 represents the view that markets must be competitive in a kind of neo-classical sense: no impediments to trade or exchange and no distortion of competition (there should be a “level-playing field”). Line 2 corresponds to a more relaxed view of market competition, stressing dynamic aspects (more or less as suggested from the Austrian

perspective). The four combinations that ensue have different implications with regard to political decentralization or centralization.

[Table 1 about here]

It must be noted at the outset that our discussion is about the contemporary world -- neither the distant past nor any utopia. Two characteristics of modernity are relevant for our purpose. First, the question of internal free trade or completion of a common market within a single country (or, for that matter, within the EU) is much less about border impediments to the exchange of material goods than about non-border impediments to the exchange of services and factors. Second, in contemporary democracies, the population is accustomed to levels of regulation, public services and welfare provisions whose drastic reduction is politically unfeasible; in other words, the role of the state has little to do with what it was in the nineteenth century and ambitioning to return to what it was then is utopian.

A consequence of these two points is that the first combination (noted 1.1) in Table 1 is unfeasible. If there is political decentralization, the policies demanded by the public, and consequently the policies provided by the sub-central governments, will fragment and distort markets in ways which are incompatible with completing the internal market in the sense given to that task in Column 1.¹ In other words, the two requirements are incompatible. One of the two must yield. If it is the requirement about competition which gives way, we move to combination (2.1) in Table 1: taming the Leviathan by political decentralization and mobility-based competition among sub-central governments under a conception of competitive markets that allows for some impediments to trade and distortions of competition. If the requirement which is relaxed is the one about government, we move to combination (1.2): reliance on political centralization to satisfy the incompressible demand of the population for public services and regulation and, at the same time, maintain or promote a complete internal market

¹ Genuine political decentralization fragments markets and distorts competition among firms (Breton and Salmon 2001). This is necessarily so whenever subcentral governments, whether regional or local, are given significant powers and autonomy, and in particular are encouraged to undertake innovative policies. Some differences in regulation among regions are a consequence, at any point in time, of the freedom to innovate. Others are related to local conditions, including the nature of the political equilibrium. Whatever their causes, many regional differences regarding regulation will generate non-tariff impediments to the exchange of goods and especially services across regional borders. Competition among sub-central governments to attract people or investments takes the form of State aids, tax holidays and various forms of in kind support. All have in common the consequence, at least as a side effect, of distorting competition among firms – and thus of precluding the maintenance or establishment of a perfectly “level-playing field.” The observation of decentralized federations such as Canada and Switzerland confirms these facts. And so does, to a lesser degree, the observation of the United States.

-- that is, at the same time, eliminate all barriers to trade and distortions of competition. In the case of combination (2.2), the level of political decentralization is, in our framework, indeterminate.

The taxonomy is useful to explain the difference between Reaganomics and Thatcherism with regard to political centralization or decentralization (Salmon 2010b). The first corresponds to combination (2.1) – or, from a dynamic perspective, to a move from combination (2.2) to combination (2.1). The second corresponds to combination (1.2), or to a move from (2.2) to (1.2). Political decentralization in the first case, political centralization in the second, in both cases as a manifestation of economic liberalism. In the case of Thatcher, the logic manifested itself a little in the United Kingdom (UK) itself but mostly at the level of the EU, where the objective of “completing the internal market”, which was almost enthusiastically endorsed by the British Conservatives, especially on the occasion of the Single Act of 1986, has been and still is the main engine of centralization in favour of Brussels (Salmon 2003). Admittedly, the hostility, not to centralization in general but to its expression in the EU context imposed some limits to the actual movement (in the UK the limit resulted from the fact that the country was already very centralized). In the case of Reagan, decentralization was eventually limited because of the need to respond to citizens’ demand without allowing excessive impediments to internal competition and trade. In both cases conflicting concerns and the necessities of compromise limited the magnitude of the changes. It remains that they were divergent, as illustrated in Figure 1.

[Figure 1 about here]

The framework presented above is useful also to interpret the system advocated by Weingast (1993, 1995) under the name of “market-preserving federalism”. In it, “the authority to regulate markets is not vested with the highest political government in the hierarchy” and “the lower governments are prevented from using their regulatory authority to erect trade barriers against the goods and services from other political units”. According to the author, this was more or less the system adopted in the United States in the nineteenth century and, in that case, it was constitutionally entrenched and enforced by the Supreme Court. The basic underlying mechanism, in the Weingast contributions of that period, is that of mobility-based competition, more or less as in Brennan and Buchanan (1980). Its virtues were presented as follows by Yingyi Qian and Weingast in an article published in 1997 (cited in Treisman 2007, p. 74): “Just as market competition pressures firm managers to reflect the interests of

shareholders, competition among local governments helps to limit government's predatory behaviour. Mobile resources can quickly leave jurisdictions with inappropriate behaviour. Competition for mobile sources of revenue prevents local political leaders from imposing debilitating taxes or regulation."²

Where should we classify "market-preserving federalism" in the framework of Table 1? There are two possibilities. We can decide that it corresponds to combination (1.1), and assert then that it is not and cannot be realized or approximated in the contemporary world (the nineteenth century is another matter).³ Or we can categorize it as combination (2.1), and concede therefore that it may preserve markets albeit only inasmuch as this is understood in the less demanding sense used to define that combination. Because Weingast illustrated "market preserving federalism" not only with the experience of the United States in the nineteenth century, but also with the system currently in place in Communist China, the second interpretation probably corresponds better to what he had in mind

Anyhow, in recent years, there has been a shift in Weingast's analyses, reflecting perhaps a more general change in the focus of the debate to which they purport to contribute. In his more recent writings (*e.g.*, Jin, Qian and Weingast 2005, Weingast 2009), pro-market policies are no more in the fore. They are subsumed under pro-growth policies. Decentralization is claimed to be an essential component in the economic success of the Chinese system because, in that system, subcentral governments are given a large share of the surplus generated by growth. Given the actual rate of growth, that distribution of the surplus may be claimed to have provided sub-central governments with a financial incentive to adopt pro-market policies if one thinks that pro-market policies are mainly responsible for economic growth. If one has a more qualified or hesitant opinion, the incentives given to these governments by the distribution of the growth surplus may still be deemed important by having induced them to adopt the policies which they thought, correctly, to be the best for growth, whether or not these policies were pro-market.

The argument, however, may reflect a continuing distrust of central government. As noted by Treisman (2007), the implication of a larger share of the surplus given to the subcentral jurisdictions is a smaller share retained by the central government, whose incentives to adopt pro-growth policies are, following the logic, diminished as a consequence.

² This comparison turns out to be somewhat unhappy in the light of what we discovered recently about financial markets and remunerations of managers in private firms.

³ This is the interpretation adopted by Richard Bird and François Vaillancourt (2006) when they write: "It should be understood that Canada is not, and never has been, a full internal common market" and "Regulatory federalism in Canada... does not easily fit the Weingast (1995) conception of "market-preserving federalism".

But, if there is no reason to distrust the central government more than the subcentral ones, one may interpret Weingast's financial incentives approach as relevant not for the justification of political decentralization but for the way financial resources should be shared in an already existing decentralized system. In fact, the generalized interpretation of his argument could be simply that financial incentives should follow the assignment of powers or competencies, nothing being logically asserted about the assignment itself —as (as we just saw) nothing is really implied by the financial incentives argument regarding the role of markets.

III. Democratic mechanisms and international yardstick competition

The view that voters are at a disadvantage because of information asymmetry is an essential element in the economic approach to politics. But sharing that view should not lead to write off the democratic -- or "consent" (Breton 1996) -- dimension of economic governance. Information asymmetry, although a serious problem, does not make office-holders unaccountable to voters. In democracies, the freedom of office-holders to diverge from the interests or views of citizens exists but is limited whereas, in non-democratic systems, that freedom is greater but also faces in general limits related to citizens' acquiescence.

An apparently innocuous assumption made implicitly in much of the political economy literature is that there is only one jurisdiction or polity. Used as an implicit supposition at the top of a deductive system, that assumption is responsible for much of the pessimism often displayed about democracy. In the assumed setting, it seems obvious that the assessment by voters of many policies and their results will be difficult, especially in the presence of historical change, shocks and uncertainty. When the assumption is relaxed, and the openness of a jurisdiction to information flows from outside is acknowledged, the problem raised by information asymmetry still exists but is mitigated. Why the difference? There are several changes brought in by openness. The one we focus on is the fact that the inhabitants of a jurisdiction have now some possibility of comparing states of affairs in their jurisdiction with situations elsewhere, in other jurisdictions.⁴ Office-holders' awareness of the existence or possibility of these comparisons affects their behaviour. If pressed by electoral competition -- or, more generally, if in need of opinion's support -- they want to be judged as performing comparatively well (Salmon 1987). This is the basis of what has been called "political

⁴ A second reason, which we neglect, is related to the provision of independent information on what is happening inside the jurisdiction. This is particularly important when the information generated within the jurisdiction is repressed or manipulated by office-holders.

yardstick competition”, which, under favourable circumstances, may strengthen the right kind of incentives in governments (not only the politicians in office, but also, indirectly, the bureaucracy, the legislature, the courts, the political parties, etc.).

Obviously, for these comparisons to be at all possible -- that is, for information from outside a jurisdiction to be possible -- the simultaneous existence of several jurisdictions or governments is a necessary condition. Federalism and political decentralization imply such simultaneous existence and consequently constitute one way office-holders might be made more accountable. But another way is simply the openness of each country to information about the state of affairs in other countries. I submit that yardstick competition at the international level is a rapidly increasing force whose influence on public policies and institutions is observable everywhere. This is a relatively neglected but major aspect of globalization and interdependence.

The reasons for the increasing strength and relevance of the yardstick competition mechanism at the international level are not difficult to figure out. Without trying to separate cause and effect, let me mention some. The flow of comparative information produced by international organizations, national administrations, research institutions, private entities and individuals has become much larger. People are more and more interested by these comparisons, and concerned with where their country stands exactly in all kinds of leagues. That greater curiosity or appetite is reflected in more detailed and precise, as well as more easily consumable, information circulated by the media. These trends are favoured by the international mobility of a large proportion of the population, related to work in particular, and they are amplified by a rapid and universal process of learning and practicing English as a second language or *lingua franca*. One may also observe, as confirming evidence, that references to various forms of ranking have become commonplace in the declarations of officials and in the public debate.⁵ That phenomenon does reflect yardstick competition because it would not happen if many voters, or more generally citizens, did not also reason, at least to some extent, in these comparative terms.

Although, the importance of yardstick competition among national governments is increasing rapidly, it was never insignificant (Salmon 1987, 1991, 1997). Why, then, has it

⁵ The influence of PISA, and the rank occupied by Finland in it, on the public debate on primary education in France are documented (and deplored) by Nathalie Bulle (2010). International comparisons are perhaps less natural in the United States than, say, in European countries. Still, the *Financial Times* (30 July 2010) reports that President Obama, in his plea for reforming education in the United States, pointed out “that America has been dropping steadily down the international league tables, particularly in mathematics and the sciences” and “that it now ranks 12th in the proportion of its people who graduate from college compared to the first place a generation ago.”

received relatively little attention? Three factors, ideological, sociological and technical-methodological, have played a role. The ideological factor is related to the discussion in the previous section. If, because of yardstick competition, voters are better informed and office-holders are more accountable to voters, there will be less possibility of discretionary behaviour, and thus less governmental or bureaucratic slack and more alignment of public policies with what voters want. Do such effects of yardstick competition when it works well (not always the case) have a bearing on the system of economic governance? That question does not arise in a significant way in the case of yardstick competition among junior governments because the economic system is not generally determined at that level. It is mainly at the national level that there is a lively political debate about the size of government and its role in economic affairs.

In practice, we should consider analyses based on competition among governments of the yardstick competition variety as largely neutral with regard to the economic system. Inasmuch as international yardstick competition improves governance, this may affect the degree of reliance on markets in any direction. On the basis of what they observe, voters can consider that an economic system in force abroad works better than their own because it relies more on markets or because it relies less. Actually, it is the first kind of belief which has prevailed in recent decades.⁶ However, a pragmatic approach to the matter is not adopted by all. In the context of an ideological divide framed as “state versus markets”, some partisans of markets may fear that any kind of perceived improvement in the accountability of government could have an effect on the economic system in the direction of less reliance on markets.

Ideological concerns may thus explain the reluctance of some, but the sociological and historical factor has a more general and directly relevant impact. Research in economics, as in other disciplines, is necessarily segmented. Political yardstick competition was introduced in the context of fiscal federalism, decentralization and public finance (Salmon 1987, Besley and Case 1995) and it has inspired innovative empirical work and theoretical elaborations in the corresponding research areas by researchers generally specialized in these areas. In their work, the variables studied have remained those they are familiar with -- mainly taxes, but sometimes also public spending and service delivery -- on a particular level of sub-national

⁶ For a liberal (pro-market) perspective in which yardstick competition is nonetheless given a very positive role, see Bernholz and Vaubel (2007).

government (regional or local), and in a given country or part of it.⁷ There is still much interesting work to do in that setting and little incentives to move out of it.

The absence of incentives is particularly decisive because of a third factor, whose nature is technical and methodological. The approach which has proved fruitful to identify yardstick competition between sub-central governments in a single country cannot be transposed without care to the study of yardstick competition among national governments. Local taxes in a country are embedded in the set of fiscal arrangements adopted for the country as a whole (neglecting here the case of decentralized federations in which regions may have different fiscal systems). This facilitates the comparisons of variations of a single tax (*e.g.* a property tax) across local jurisdictions. With some exceptions (such as taxes on petrol or on cigarettes), comparing a single tax, or its variations, across countries is likely to be misleading because fiscal arrangements, and more generally institutional or systemic arrangements, are quite different across countries, with the possibility that various kinds of compensation allow national systems to yield in their own way results that, in the end, are not so different.⁸ I have mentioned taxes but the problem is more general.

This does not mean that voters will not engage in international comparisons. We have just observed that they do and increasingly so. But the differences in the two realities have two important implications. The first is that the variables which are the most fit to be compared across countries are likely to be different from the ones typically compared within a single country -- the case of decentralized federations being ambiguous.⁹ If comparisons of variations in single taxes make less sense across countries than they do across sub-central jurisdictions, what are the variables that are most likely to be compared internationally? Legislation on salient or topical issues makes up a first category. It may include matters such as divorce, abortion, capital punishment, same-sex marriage, illicit drugs, smoking, the construction of mosques and the wearing of *burquas*. Inasmuch as sub-central governments in decentralized systems have the right to legislate on these matters, there is no real difference here between sub-national and international comparisons. So far, however, the literature on the diffusion of legislative innovations across sub-national jurisdictions has not (as far as I

⁷ Research in economics and political science is fragmented along other dimensions (anything international being separated from the rest, for instance) that may also be significant for our discussion, but the one mentioned in the text is certainly the most important, and in any case the most obvious.

⁸ These considerations are compatible with the empirical evidence of mimicking of single tax variations at the international level. However, that is to be explained by mobility-based tax competition rather than by yardstick competition. (see for instance Devereux, Lockwood and Redoano 2008).

⁹ In decentralized federations, legislation on sensitive issues as well as performance in many policy areas are determined, in varying proportion, by the two levels of government. Comparisons, in consequence, are relevant both across sub-central jurisdictions and across countries.

know) given much attention to yardstick competition. Anyway, a second category is more interesting for our purpose. It consists of performance, or quality in the delivery of services, in policy areas such as education, health, public transportation and sports. On these matters, voters, or various subsets thereof, may compare the situation in their own country with what they know of the situation in some others or they may pay attention to the rank of their country in the various comparative statistics made available by the media. Again, there is not much difference here between the international and the national settings except perhaps that, in many policy areas, there is more relevant information easily accessible for international comparisons than there is to compare the achievements of regional or local governments. Performance of a macroeconomic kind constitutes a third category. Economic growth or more short-term variations in macroeconomic variables are naturally perceived as concerning above all the national level rather than any sub-national one. This is in part because sub-national governments have less means to influence these variables than have the central government. But, the main reason is probably the ambiguous bearing on individual welfare or utility of the values taken by the variables at the subcentral level. This is particularly true in the case of local government. The growth of cities may be a source of pride or envy in some cases but a mixed blessing or a thing to avoid in others. Increasing income per head at the local level may reflect “gentrification”, without any clear-cut implication with regard to performance.

The difference between the two contexts in which yardstick competition among governments takes place has a second implication, which concerns the way empirical evidence can be sought. That implication is related to the first. The sophisticated techniques (spatial econometrics, for example) applied to yardstick competition among governments over a single variable like a property tax cannot be easily transposed to empirical assessments of yardstick competition over variables such as rates of economic growth or performance in the delivery of a particular category of services. Several obstacles to such transposition come to mind. Mimicking, which has played such a large role in the empirical literature so far cannot be given the same meaning when the comparisons made by voters are about performance. Mimicking a rate of economic growth, or the level in mathematics of schoolchildren, is not meaningless but it is definitely different from mimicking a tax rate. The comparisons made by voters are not dissimilar and have more or less the same kind of influence on their electoral choices, but the way policies may respond to these comparisons are different. In the case of performance, the response will be roundabout rather than direct. Underperformance in one area will lead to increased effort and to adjustments in policies apparently distant from that area. The government of a country observed to do better than others may relax or redirect its

efforts to other domains. Even if nothing should let us suppose that it will prove impossible to use rigorous methods to test or estimate yardstick competition over performance at the international level, it is clear that finding ways to apply them for that task is difficult. Hesitation to undertake work in that direction is understandable.

Given all these difficulties and caveats, and if only to be on the safe side, one possibility is to assume that only serious underperformance will be noticed by voters and/or may generate a level of discontent which, if left unchecked, would impose policy change. The level of underperformance which will not be tolerated depends *inter alia* on the willingness and capacity of voters to engage in comparisons, on the impact of these comparisons on their support to office-holders, on the intensity of political competition within the jurisdiction and thus on the degree to which voters' dissatisfaction reduces the probability of incumbents' re-election. Figure 2 -- inspired by Figure 7.3. in Salmon (1997) – illustrates the general idea.¹⁰ With some additional specifications or assumptions, the underperformance measured on the horizontal axis could affect all kinds of variables.¹¹ But, for the moment, I will assume that it concerns a central one, macroeconomic performance (e.g. economic growth). Voters' dissatisfaction generated by underperformance is measured on the vertical axis. Horizontal broken lines indicate the maximum level of dissatisfaction tolerable without policy change.

[Figure 2 about here]

Two values, A and B, for the maximum level of underperformance that can be tolerated without any policy change are indicated in Figure 2. The difference between the two is the result of a different relationship between underperformance and dissatisfaction (curves OV and OW) and a different level of political tolerance of dissatisfaction (lines T_W and T_S).¹²

Assuming that yardstick competition among governments at the international level works with full force, where does that leave yardstick competition at the level of subcentral governments? Suppose for a moment that accountability concerns only one variable or dimension. Inasmuch as international yardstick competition improves the accountability of office-holders and thus the quality of economic governance in a country, this makes it less

¹⁰ That geometric representation is also used in Salmon (2010a).

¹¹ Under the assumption of probabilistic voting and intense political competition, all categories of voters will count and office holders will attempt to avoid, *ceteris paribus*, that any subset of voters become seriously dissatisfied.

¹² It is easy to see that a flattening of curve OW and/or an upward displacement of line T_S could well result in no level of underperformance being politically intolerable – that is, imposing policy change. But such outcome is unlikely in democracies, at least for salient or central issues such as economic growth.

likely that decentralization in that country and the yardstick competition among subcentral governments that ensues will be as accountability-enhancing as it would have been if the country had been closed to international flows of information. This means, in that single dimension case, that yardstick competition processes at the different levels are largely substitutes. As already argued in Salmon (1991), a small economy open to information flows from abroad (think of Monaco) will not gain very much in terms of accountability of its office-holders by adopting a federal and decentralized political system. In a large, relatively closed economy with regard to information flows, such adoption may improve accountability more significantly. If, more realistically, we assume that governmental performance is assessed along several dimensions, there is a role for yardstick competition to play in a complementary way on different governmental tiers as well as internationally.¹³ The level of local taxes or the provision of recreation facilities is likely to be central in the comparative assessment of local authorities by voters whereas economic growth performance is a particularly suitable object of international comparisons.

If international yardstick competition is vigorous, however, comparisons of growth rates or income per head will give central governments an incentive to ensure that the national economy does not fall too much behind, whether or not the governmental system is decentralized. By itself, this concern may inspire many kinds of institutional and policy changes in areas that are not directly related to macroeconomic performance. Yardstick competition at the international level may make a national government responsible for the performance of the country also in policy areas in which decision-making is decentralized and thus induce the national government to seek changes in decentralization arrangements in these areas or to limit their consequences. In the next section we elaborate on these perspectives.

IV. Changes in decentralization arrangements in response to bad performance

4.1. The general idea

The considerable amount of empirical work done on the relationship between decentralization arrangements and many variables of interest is interesting and useful, if only because it rarely

¹³ In the spirit of Holmstrom and Milgrom's famous analysis of multi-tasking (1991), we can observe that, when a government has several tasks, it may concentrate its efforts on those that are easier for others to measure (and thus to reward or sanction), and neglect the others. A radical way to address the problem is to implement single-task overlapping jurisdictions, as suggested by Eichenberger and Frey (2006, e.g.). The classical distribution of tasks among several levels of government is a less ambitious but reasonably effective way to limit biases resulting from multi-tasking.

confirms the existence of robust and significant relations between the two sets (see Treisman 2007, Boadway and Shah 2009). With regard to economic growth or income per head, there are few if any reasons to predict that countries which have more decentralized – or, for that matter, centralized – arrangements will be found to have a higher rate of economic growth or a higher income per head. It will all depend on many idiosyncratic characteristics of the country. In some cases political decentralization will be complementary with the way the market functions, and the association of both will be growth enhancing. In other cases, a high level of intervention by the central government will prove more favourable to growth. The combination which works best in France or Japan, given the traditions of the countries, the way their elites are educated, the mentality of their citizens, etc. may be different from the combination which works best, say, in Switzerland or China.

This is an instance of a more general phenomenon, affecting several domains of applied economics. There are many questions about the real world on which generalizations are hindered by the existence of pervasive idiosyncratic complementarities. In some cases, it is possible to identify forces that will prevent gross maladjustments. In the case of the governance of firms, many different arrangements co-exist, in forms varying across countries or across firms within single countries. Generalizations about the governance of firms are more fragile than is often asserted. A conjecture may be formed, however, that a given business firm, in a competitive environment, will have some incentive to adopt the form of management and control which is the most appropriate to its particular circumstances, or at least that it will have an incentive to change the arrangements in force if they turn out to be seriously deficient or unsatisfactory along some dimension deemed essential.¹⁴

National governments are not in the same situation as firms. But, in the last section, we have identified yardstick competition among national governments as a force which may prevent severe underperformance in a given country. It will generally operate together, or interact in a complex way, with mobility-based competition, but we will not discuss explicitly that second form of intergovernmental competition or the way it may interact with the first. In the governance of countries as in that of business firms, competitive forces, although of a different nature, will exert some pressure to improve existing arrangements if these are responsible for outcomes that prove insufficient in the presence of the said competitive forces.

¹⁴ This proposition does not come down to a Lamarckian version of the famous theory, exposed by Armen Alchian and Milton Friedman in the early 1950s, according to which competition will ensure the satisfaction of the marginal conditions for profit maximization. The mechanism they relied on was the natural selection of the firms, whereas we want to stress the selection of governance arrangements. It is not certain that a real difference is involved here. What is more important to note is that we keep shy of referring to optimality.

This will follow a trial and error pattern – or, in the language of Karl Popper, a conjectures and refutations pattern.

Instead of the usual cross-section analysis relating states of decentralization and performance, our reasoning suggests focussing on the relation between *changes* in decentralization and either *levels* of performance or *changes* in these levels, these variables being measured in absolute or preferably comparative terms. To make the suggestion somewhat more precise (at the cost of making it even more tentative), let me formulate the following two-pronged hypothesis:

- H_A: some of the observed changes in decentralization arrangements in country *j* are preceded by observed serious (comparative) underperformance;
- H_B: some of the observed changes in decentralization arrangements in country *j* are followed by an improvement in observed (comparative) performance.

The hypothesis could concern macroeconomic variables like the rate of economic growth or sectional ones like education or health. The typical adaptation pattern is likely to be different in the two cases.

4.2. Underlying mechanisms.

The response to underperformance may take different forms or be explained by different mechanisms. We distinguish among three categories.

I) In the first, which was more or less assumed, implicitly, in the foregoing discussion, the central government judges that existing arrangements must be amended so as to improve a seriously deficient performance. We suppose that the central government has the capacity or authority to set off the changes. We, as observers may not be able to say whether the contemplated arrangements are better than the existing ones, but the central government has reasons to think (tentatively) that they do. Decentralization arrangements may or may not be involved in the changes. They are more likely to be needed in countries which are federal or already decentralized than in centralized unitary states. However, the general pattern is easier to expose in the case of the latter.

In unitary states, many reforms are just decided and implemented by the central government. In general, changes in decentralization arrangements are not needed. Only in some instances will the central government or office-holders in the central government decide that changes in decentralization arrangements are necessary or useful to implement reforms improving performance. If that happens, it would be a mistake to think that the said changes will always be in the direction of decentralization rather than centralization. Unitary states,

even when centralized, are not centralized to the point that further centralization is impossible or unlikely. A case in point is the UK under Thatcher, as we saw in Section 2.

Over the last decades, however, there have been many instances of decentralization decided by the central governments of unitary states. Do they fit our hypothesis? A difficulty is the role played in that hypothesis by underperformance and especially its comparative dimension. This element is lacking in some experiences that come to mind. Decentralization in China or the decentralization reforms implemented in France in the early 1980s, for instance, do not fit in well with our hypothesis. They did improve performance along some dimension but did not follow comparative underperformance and were not a manifestation of international yardstick competition

A scenario that does fit is the following. It is observed in country A that a much better performance in some policy area has been obtained in other countries and this puts some pressure on the government of A to do something. The central government of A has reasons to think that the existing organization of multi-level governance has some responsibility in the underperformance of A -- because there is too much centralization, for instance. The central government undertakes changes in decentralization arrangements. The changes may aim at establishing or strengthening competition among sub-central governments. Or they may pursue other objectives. Among the reasons the government A has to think in this way, the observation of decentralization arrangements in better-performing countries may or may not play a role. For instance, the central government of A may think that the superior performance of B in the said policy area is caused by decentralization. This may or may not be true. Even if decentralization is for something in the superior performance of B, that does not prove that decentralization will work in A, given complementarities in the two countries that are mainly idiosyncratic. The changes made by A will thus always be a trial in a sequence of trial and error, but our hypothesis says that changes in decentralization arrangements introduced because of underperformance in some policy area will improve performance in that policy area on average. This stems from the assumptions that national governments know what they are doing and that yardstick competition at the international level forces them to limit underperformance.

As noted, changes in decentralization arrangements are more likely to be involved in the case of reforms undertaken in countries whose system is federal/and or very decentralized than in unitary centralized states. The reason is that, in the former, subcentral governments have the capacity to block or delay reforms which they do not like. In other words, federalism and political decentralization increase the number of veto powers, which increases stability

but plays against reforms. To overcome vetoes, one way is to change the distribution of powers or competencies but this often requires a modification of the constitution itself which will often prove difficult (possibly because of the veto powers of the same actors). Thus negotiation and contracting will often be the main path borrowed to get the acquiescence of the subcentral governments. Decentralization arrangements are likely to be changed in that kind of process, albeit in an informal way. Other ways to circumvent the opposition of subcentral governments may be part of vertical competition, which we discuss below.

2) The same empirical hypotheses could be derived from a different but related mechanism. Many years ago, Mancur Olson (1982) stressed the negative effect on economic performance of a slow process in which collective decisions are progressively captured by the increasing number of interest categories which manage (in spite of the logic of free riding) to mobilize themselves into organized pressure groups. If unchecked, this process tends to generate over time a sclerosis of the economic system. Ronald Wintrobe and Albert Breton (1986) proposed a mechanism based on the accumulation of trust that may lead to a comparable result. According to Olson, a positive side effect of major disruptions such as revolutions and wars is that of destroying the mobilization underlying the organization of the pressure groups and thus the basis of capture itself. Thanks to the disruptive events, the economy is liberated and can grow again or more rapidly.

Drawing some inspiration from the story, we may form the hypothesis that politicians in office can change the decentralization arrangements just for the sake of disaggregating networks that are a cause of persistent underperformance. For instance, if decision-making on education is concentrated at the level of the central government and is captured by a coalition between the education officials located at this level and the teachers unions, transferring competencies in that area to a lower level of government may be a way to destroy the network or coalition and improve performance in education – and as a consequence, if that area is deemed important, perhaps performance of the economy as a whole. Or it may be the other way around – that is, transferring the competencies from the lower tiers of government to the higher tiers may do the job. A strategy of that kind may underlie in some cases the empirical hypotheses mentioned above. And its repetition could also account for a more extended sequence, in which decentralization and recentralization are observed to alternate – although such observation might simply reflect the trial and error pattern mentioned earlier. Contrary to received wisdom, institutional instability, albeit of a particular kind, might thus have a positive rather than a negative effect on performance, whether in term of economic growth or with regard to the delivery of services in some policy area. .

3) In both the mechanisms just discussed, the central government or the politicians in power at the central level respond to underperformance under the pressure of voters. Subcentral governments play a secondary role -- completely passive or mainly negative. In the third mechanism, their role is supposed to be central. The same variations in decentralization and the same relations between them and performance may result from the actions of many or some of the subcentral governments, either without or together with the central government. In the case of the EU, and in particular on the occasion of the Single Act, the governments of the member countries negotiated the changes among themselves and with the Commission, and they had the last word. In fact, this is the general pattern in the EU setting, although some important changes in the EU governmental system (direct effect, supremacy of the European law, etc.) emanated from the European Court of Justice. Something of the like can also be observed in federations when regional governments play a deliberate collective role in the evolution of competencies.

Variations in decentralization arrangements can also be the effect of a dynamic version of the efficiency-enhancing vertical competition among governments analyzed by Breton (1996, 2006, *e.g.*). The underperformance of the overall governmental system in some policy area, might, in a context of competition for consent, trigger a response from the regional governments, or some of them, rather than from the central government, and this may eventually bring about a durable change in decentralization arrangements in that policy area or more broadly. As showed by Breton, the effective distribution of interventions or responsibilities of the different levels of government is not constrained by the official distribution of exclusive powers, where it exists (concurrency is often the official rule). Powers may always be reinterpreted or used in such a way that they allow governments to penetrate into domains that seemed to be the exclusive playing ground of other levels of government. When the central government does not respond to serious underperformance, one or several subcentral governments, pushed by voters, or just hoping to increase their support, may step in and undertake to do the job. Depending on the reaction of the central government, this may or may not result in a durable reassignment of competencies.

The federal or unitary nature of the governmental system has certainly a bearing on the relative importance of these various processes and on their specifics. Let us note also that the three mechanisms just discussed are not the only ones that can conceivably underlie our hypothesis. In some historical contexts, the main response to a politically intolerable degree of underperformance may come from a political party, an oligarchy (religious or secular), the army, some other segment of the bureaucracy, and so on. These possibilities should be kept in

mind principally when seeking real-world illustrations of our hypothesis, a matter discussed in subsection 4.4.

4.3. Limits, objections, qualifications

Many objections need little elaboration because they are so obvious. Others are so fundamental that it is preferable to gloss over them. We will consider three points. First, obviously, it must be readily conceded that many reforms whose purpose is to improve economic performance do not call for any kind of change in decentralization arrangements. As we saw, this is particularly likely to be the case in centralized unitary states. Conversely, many changes in decentralization arrangements, related for instance to equity concerns or to ethnicity and cultural heterogeneity, do not have any direct relation with economic performance. This was implicit in the foregoing discussion, in which we stressed the role of idiosyncratic complementarities in the arrangements adopted in each country; it is clear that changes in the underlying variables, most of them of a non economic kind, can impose changes in decentralization arrangements.¹⁵ These considerations justify the caution used in the formulation of our hypothesis, which is meant to apply only to a subset of observed changes.

It should be noted, however, that many changes in decentralization arrangements which seem to have no relation with economic performance do have a strong link in reality. Finding solutions for issues which seem to have no relation with economic performance may be a precondition for improving that performance. If, for instance, more autonomy to a region is conceded on grounds that have no economic character at all, but are related, say, to some form of ethnocentrism or “regionalism”, and if this increased autonomy is accompanied by a diminution of transfers, this may have a positive incidence (via better incentives) on the growth rates of both the region and the rest of the country – improving consequently the performance of the country as a whole.¹⁶ There may also be an important indirect growth impact of changes in decentralization arrangements when these arrangements involve natural resources (Brosio 2006). Without some consent about ownership or the distribution of revenues, the exploitation of these resources, and with it overall growth, may be hampered (an obvious case is Iraq). Political necessities may also be responsible for the need to changes decentralization arrangements, This may happen if the political support of a party mainly

¹⁵ An example would be demographic changes affecting the distribution of the population with regard to linguistic affiliation in Belgium, to religious affiliation in Lebanon.

¹⁶ Such possibility is suggested (indirectly) in Salmon (2010a) with regard to the underperforming regions of France, Germany and Italy.

concerned with such changes is needed for the adoption of a reform aiming at improving economic performance.¹⁷ However, even though these types of purely political linkages might be difficult to filter out in empirical work, they do not really fit in well with our hypothesis, which is based, even if only implicitly, on causality. What we want in general is a significant effect, direct or indirect, of decentralization arrangements on growth. Decentralization based on purely political, coalition-building, necessities, when it enables reforms that enhance growth, constitutes at best a borderline case.

Second, we have often referred to variations in *levels* of decentralization. In some cases, the use of that term raises no particular difficulty. But in many circumstances the term cannot or should not be employed.¹⁸ A first reason is that decentralization and centralization can be measured along many dimensions -- the most widely used (*i.e.*, the share of spending by subcentral government in overall public spending) being perhaps the most misleading of all (see Stegarescu 2004). A second reason is that many very important changes in what we have called decentralization arrangements cannot be measured quantitatively at all, whatever the variable measured (this is the case of the changes in Australia to be discussed in subsection 4.4). Let us note in passing that a particular bias generated by the (understandable) concern with employing quantitative indicators is the tendency of the literature to focus on financial matters whereas, in many cases, decentralization arrangements concern above all law-making and regulation. For instance, the centralization in the EU context referred to earlier is not really a matter of finance but one of regulation.

This being said, in an informal way, without quantitative measurement, we may still often speak of movements of centralization or decentralization, for instance when powers are redistributed or because truly democratic decision-making centres are created at levels of government on which there were only administrative bodies (e.g., regional authorities in the case of the French decentralizing reforms of the early 1980s).

A third reason for not referring too much to levels is that significant quantitative variation in decentralization series is very slow or infrequent. That characteristic might raise a problem for empirical work. Fortunately for the relevance of our hypothesis, changes in decentralization arrangements that do not involve quantitative variations are, on the contrary, fairly common.

¹⁷ In fact, it is a general implication of the practice of coalition building, vote-trading, linkages, logrolling and so on -- more visible in democracies but pervasive, in one form or another, in all political systems -- that all policy changes may be politically related.

¹⁸ I am grateful to Fabio Padovano for making particularly clear some of the difficulties that a quantitative assessment of the hypothesis would have to address.

The third point is about the empirical assessment of our hypothesis: The question is perhaps one of those which it would be wiser to gloss over. Not much can be said at this stage anyhow. Because our hypothesis cannot be formulated in quantitative terms, as just noted, it seems difficult to aim at any kind of confrontation with reality more rigorous or ambitious than that achieved by so-called “analytical narratives”. However, although too “soft” for some commentators, this method is still much beyond what we can attempt to do in the present paper, which is only exploratory. References to the real world are at best illustrative, as we will stress now.

4.4. Illustrations

To illustrate the sequence discussed here, Russia would certainly offer a good case study (see Enikov and Zhuravskaia 2007). The same is probably true also of India (Singh and Srinivasan 2006, Singh 2007). We already discussed the centralization implemented in Britain under Thatcher. If we remain at the level of observation, without trying to penetrate too much into the underlying causality, the latter case can be reinterpreted in the context of the approach discussed now. The observable sequence fits the formulation of our hypothesis: underperformance of the British economy, followed by changes in decentralization arrangements (that is, by centralization), followed in turn by improved performance. Taking into account causality, it is dubious that increased centralization had a highly significant role in the improvement of performance, but it may have contributed somewhat to it. As generally acknowledged in retrospect, the Single Act was a major change in the “architecture of government” at the EU level. It was adopted in 1986 in a context of yardstick competition – reflected in the obsession, widespread at the time, with ‘Euroclerosis’, a state of affair generating a state of public opinion, ‘Europessimism’ -- and it did improve the performance of the European economy. Table 2 is a sketch of some of the illustrations that could be sought.

[Table 2 about here]

I will concentrate on one case, Australia, because the story told by John Madden (2006) fits in relatively well with our hypothesis. In the context of three decades of underperformance (as compared to the OECD average) and a balance of payment crisis, the Hawke-Keating Labour governments (1983-1996) implemented, as part of a more general programme of economic reforms, a substantial rearrangement of intergovernmental relations. “The federal government’s primary motivation was to enable it to advance its microeconomic

reform program in a drive to improve the efficiency of the Australian economy (...) However much of the reform program involved areas within states' jurisdictions so that their cooperation was essential" (p. 110). The solution was sought in the establishment of what was called a system of "Collaborative Federalism" in which reforms were designed and implemented by the way of intergovernmental committees at ministerial and official levels, under the impetus of a Council of Australian Governments (replacing in 1992 the Special Premiers' Conferences). Madden apparently agrees with another author that "the extensive growth in collaborative federalism" could be seen as "reshaping Australia's federal system in a fundamental way" (p. 110). He stresses, however, that "most of the distinguishing features of Australian federalism – a very high vertical fiscal imbalance, fiscal domination by the Commonwealth, and an over elaborate system of horizontal fiscal equalization – remain very much the same" (p. 132). In the case of Australia, we have all the ingredients of our hypothesis.¹⁹ The average annual growth rate of GDP per capita in Australia underperformed that of the OECD as a whole in the 1960s, 1970s and 1980s but it outperformed it in the 1990s, and even « over the last six years of the 1990s, Australia enjoyed an average productivity growth of 2.4 per cent, which exceeded that of all OECD countries except Norway" (p. 132). The inflexion can be attributed to reforms that included substantial changes in decentralization arrangements.

V. Concluding remarks

Over a period of more than half a century, governmental decentralization has been the object of a considerable amount of work on the part of economists and other social scientists close to economics. Many aspects of the question have been analysed and a lot of empirical knowledge accumulated. One cannot, however, feel perfectly satisfied with the current research situation. A reason stressed in the paper is that there are limits to what the traditional method of economics, focussed on the deductive and empirical discovery of robust regularities, may achieve when its subject is a phenomenon like governmental decentralization (whose scope goes much beyond what is typically treated under the name of "fiscal federalism"). It is a great merit of all the research done that it provides material to support that proposition. We need not rehearse here all the problems mentioned or suggested in the course of our discussion. In many ways, expertise about decentralization should be seen

¹⁹ Except perhaps for some evidence on the way public opinion, or the political debate, was actually influenced by comparative underperformance. But only in the light of our hypothesis would one bother to seek that kind of evidence.

as an art, based on the kind of knowledge which is only translatable imperfectly into the scientific categories economists are familiar with. One might even venture to remark that scholars working in federal countries such as Australia, Canada, India, Switzerland and the United States, especially when they have reflected on the subject for many years, have a kind of implicit understanding of the mechanics of decentralization and federalism in their country that scholars living in unitary countries such as Britain and France will always have some difficulty to acquire.

This being said, it may be the case that aspects of the world lying outside their main preoccupations but having potentially a bearing on them get neglected as a side effect of the intimate knowledge just acclaimed. We have suggested in the paper that one such aspect is yardstick competition among national governments (including in that category an entity such as the EU). To our knowledge, that mechanism has remained almost completely unheeded in the study by economists of federalism and decentralization. We have tried to convince readers that it has already become a significant aspect of globalization, making comparative performance a major concern of office-holders. We have also suggested ways in which that concern could in turn induce changes in decentralization arrangements. However, the discussion has remained tentative, and references to the real world limited to a few illustrations.

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		Views on the state	
		<u>Leviathan</u>	<u>Instrumental</u>
Views on market competition	<u>Neo-classical</u>	1.1 Unfeasible in the modern world	1.2 Political centralization
	<u>Dynamic</u>	2.1 Political decentralization	2.2 Indeterminate

Table 1: Crossing views on the state and views on markets

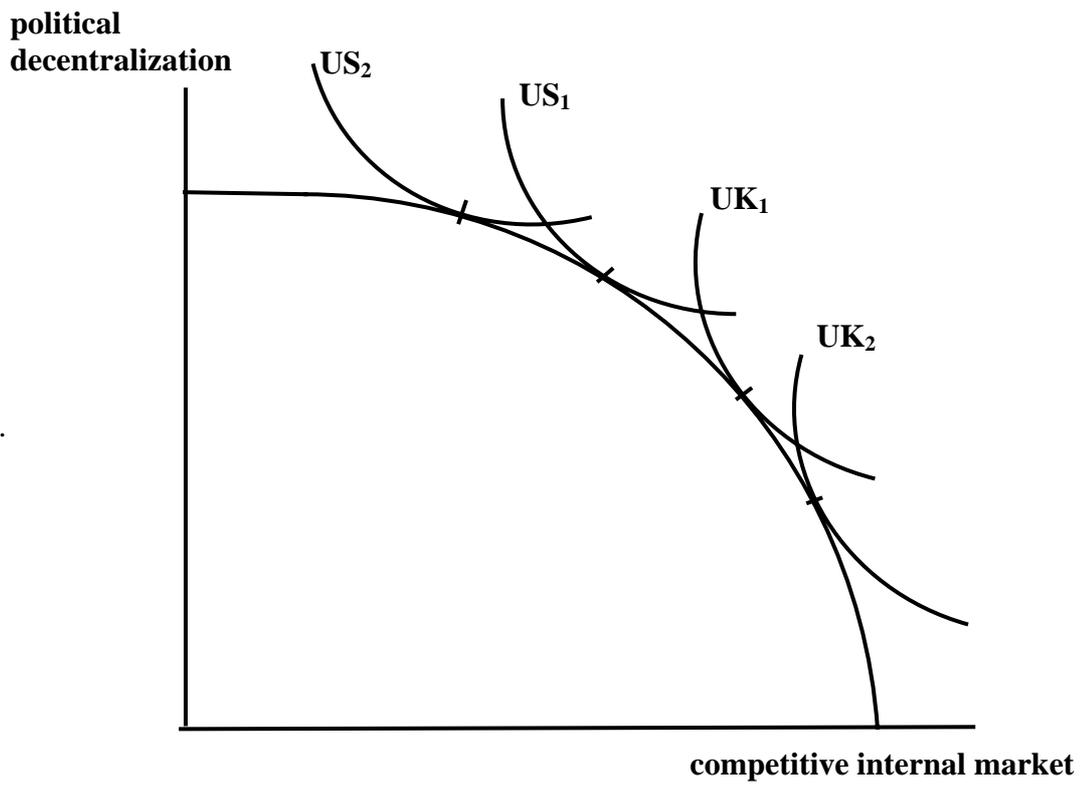


Figure 1: Reagonomics vs Thatcherism

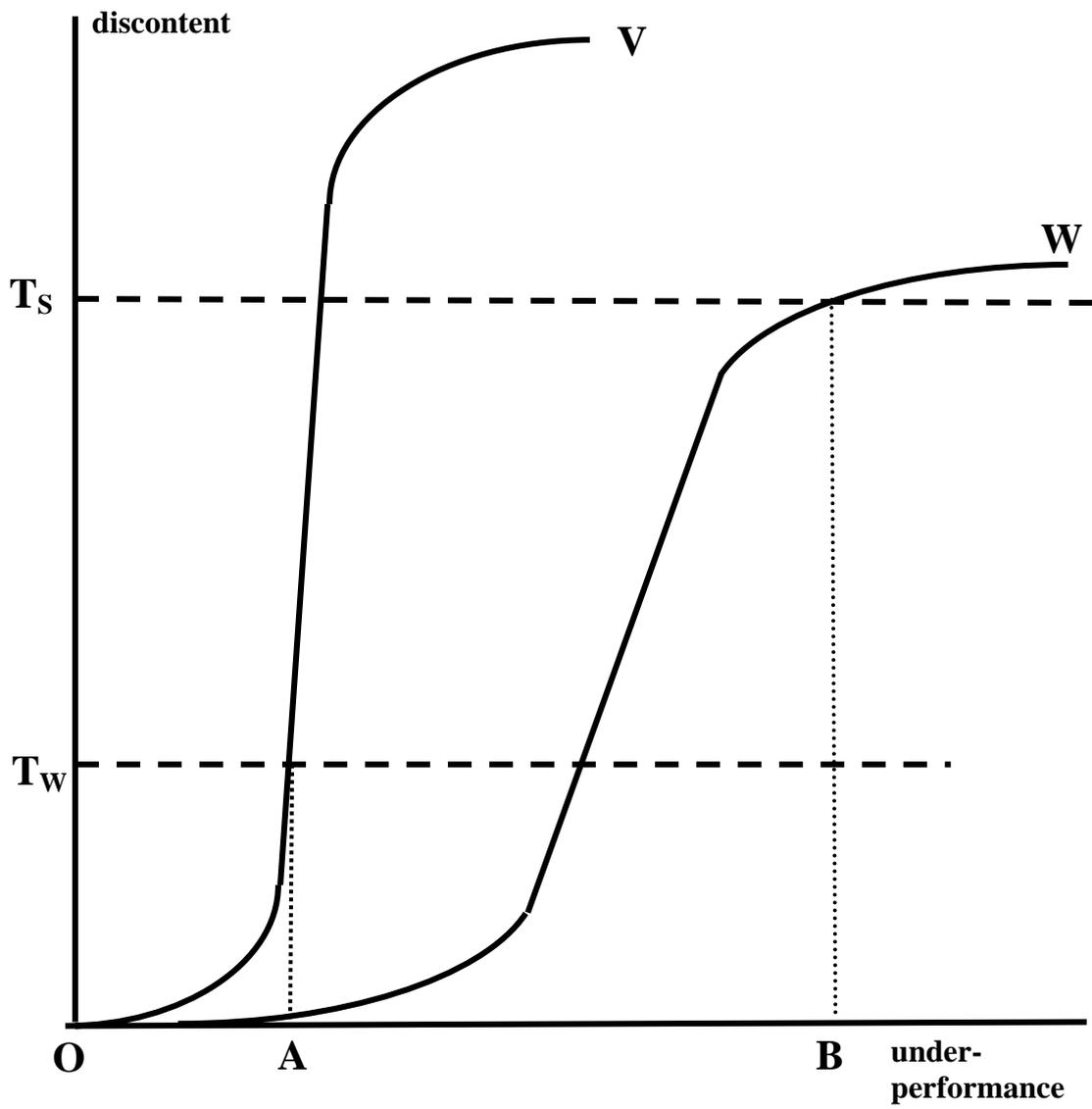


Figure 2: Maximum tolerance of underperformance

Country	References	Date(s) of reform	Follows strong underperform.	Object of reform	Changes in decentraliz. arrangements	Performance is improved	Case fits
Australia	Madden (2006)	Starts in 1983	YES “3 decades”	Liberalization and growth	YES Intergov. committees	YES (1990s)	YES
India	Rao (2002) Singh & Srinivasan (2006)	Start in the 1980s. then early 1990s	YES, “in comparison to East Asian economies”	Liberalization and growth	Decentraliz. “opens space for action by state govnmnts”	YES	YES
China	Weingast (1995, 2009)	1978	NO	Liberalization and growth	Decentraliz. + financial incentives	YES	NO
Russia	Zhuravskaia	Putin Early 2000s	YES, stagnation in the 1990s	Order and growth	Pol. recentraliz. + decentralized financial incentives	YES	YES
Mexico		Starts in 1988	YES (1981-1995)	Liberalization and growth	Decentral.	YES for a while	YES
European Union	Salmon (2003)	1986-87	YES Europessimism	Internal market (1992 project)	Centralization (Single Act)	YES, in some respects	YES
United Kingdom		Thatcher	YES	Liberalization and growth	Centralization	YES	YES (to a point)
France Universities		2008-	YES (as observed in the Shanghai ranking)	Higher rank in the Shanghai ranking	Decentraliz. and differentiation	Too early to say	It might

Table 2: Sketch of illustrations to be sought