Making Federal Competition Work for Democracy and Growth

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1. Introduction

• Is decentralized/federal competition required for industrial policy to work? Local units compete over public goods, leading to rapid policy evolution, adaptive implementation, and higher growth?

• ‘Regionally decentralized authoritarianism’ in China and Vietnam, vs.

• Race to the bottom in, e.g., US & Brazil?
Introduction...

• Huge literatures on decentralization and fiscal federalism.

• Decentralizing reforms in 80-100% of the world’s countries (World Bank 1999).

• Most studies focus on public sector outputs: e.g. education and health provision, public investment levels, fiscal deficits.

• Few studies examine economic growth or industrial policy success.
2. Empirical evidence

Some who do are...

• Rodríguez-Posé and Bwire (2004): devolution in Germany, India, Italy, Mexico, Spain, and the US usually has insignificant or negative effects on economic growth.

• Martinez-Vazquez & McNab (2003)’s survey of 120+ studies finds results mixed on both direct & indirect effects of reform on growth.

• Feld, Baskaran and Schnellenbach (2008): “Overall, the empirical evidence is rather inconclusive whether there is an effect at all.”
Empirical evidence...

- Feld et al. (2004) find that matching grants (cooperative federalism) decrease economic performance, while tax competition (competitive federalism) improves the allocation of public funds, and hence growth in Swiss cantons.


➡️ We don’t know. Odd.
3. Theory: 1<sup>st</sup>-order effects

How do we understand these results? Let’s place them in the political economy context of decentralization’s 1<sup>st</sup>-order effects.

→ 1<sup>st</sup> order vs. 2<sup>nd</sup> order effects.

What do decentralization and federalism do? They reorganize political authority, accountability, and expenditure patterns.
1\textsuperscript{st}-order effects

- 1\textsuperscript{st}-order effects on public sector efficiency, effectiveness, and quality of decision-making.

→ No 1\textsuperscript{st}-order effects on growth.

- 2\textsuperscript{nd}-order effects on growth via more efficient or effective public investment & services.

- Any effects on industrial policy must be through public investments & quality of decision-making.

→ How does this work?
4. Qualitative evidence: Viacha and Charagua
Viacha – LG was unresponsive, violent and corrupt. Mayor sabotaged accountability and public oversight.

**Evidence**

- LG expanded the payroll by >100% without increasing administrative ability or technical skills.
- Unfinished, over-budget municipal coliseum
- Exploding sewerage
- Public officials, municipal councilmen, and mayor’s political boss → mayor is corrupt
- National audit charged mayor with malfeasance.
1. **Charagua** – LG was participative and responsive, led by strong organizations of government that produced high-quality policy outputs.

**Evidence**

- Mayor topped a departmental ranking
- Operating costs kept to 4% of a municipal budget that had grown 6,500%
- National government audits concurred
- Local testimony overwhelmingly concurred
5. A model of government effectiveness

Economic Interests' Lobbying and Political Engagement

Openness and Substantive Competition of Politics

Local Governance Responsiveness and Accountability

Politics

Diverse, heterogeneous

Many active organized groups

Civil Society's Organizational Density and Ability
Governance in Viacha

- Economic Interests' Lobbying and Political Engagement
- Politics
  - Doubly divided; Low trust; Episodic violence; Collective action failures
- Openness and Substantive Competition of Politics
  - Low competition and no substantive choice → apathy
- Civil Society's Organizational Density and Ability
- Local Governance Responsiveness and Accountability

Dominant brewery was monopsonistic provider of political finance
Governance in Charagua

**Economic Interests' Lobbying and Political Engagement**

- Pluralistic ranchers
  - Highly structured, coherent APG; High trust

**Politics**

- Openness and Substantive Competition of Politics
  - Open, competitive; Entrepreneurialism; High representation

**Civil Society's Organizational Density and Ability**

**Local Governance Responsiveness and Accountability**
6. Transformation of governance: Viacha 13 years later

Viachan LG is transformed → Open, transparent and responsive.

Evidence
• All 63 rural communities now have electricity and potable water
• 70%+ of schools have internet
• Quarterly Mayor’s reports; Weekly OC reports; Spending plans down to district and community level
• 3 successive national audits praised municipality
• UNDP ranked Viacha in top $\frac{1}{6}$ of all muns
How did LG in Viacha change?

- CBN plant closed down
- Ascent of civil society – organized & assertive
- A modernizing candidate promised transparency and efficiency, was elected, and delivered

→ Political competition and example of nearby localities. Voters learned costs of conflict and paralysis
Charagua 13 years later

Charaguan LG has improved further, and participation and transparency have deepened considerably.

Evidence

- Now all rural communities have schools, health posts, and electricity.
- Budgeting and planning devolved to district and village levels.
- Mayor gives quarterly reports on works & budget.
- Communities manage budgets and projects directly.
- Charagua ranked 3rd-best nationwide.
How did LG in Charagua improve?

- APG entered into politics directly
- APG + MAS brought political stability (5 years)
- Ranchers choose to work with Guarani-led LG

In context of political competition + high participation: Good government ➔ endogenous rise in local standards/expectations for LG
7. 2\textsuperscript{nd}-Order effects

A. Well-ordered federal system can increase political competition $\rightarrow$ better policy making and more accountability (Myerson 2013).

• Alternative routes for entering national politics. Centralized politics $\rightarrow$ Oligopoly. Federalism can increase total competition, and improve policymaking.

• New opportunities to demonstrate competence. Possibility that successful local officials will advance to higher levels increases elasticity of political demand for politicians at each level below the top $\rightarrow$ better public services.

• Greater effort by subnational politicians to win popular support strengthens national party, and...

• National party support can boost local competition and so improve local policy-making quality.
2\textsuperscript{nd}-Order effects...

B. Main threat to industrial policy is politician appropriation of assets and rents. Caused by weak institutions that fail to limit government discretion and protect citizens from abuses of power (Weingast 2013).

\rightarrow Key explanation of why most new democracies fail.
\rightarrow And also fail to grow as rapidly as they could.

*How to promote democracy and growth where power-limiting institutions are scarce?*

Decentralization can square this circle by building a culture of democratic practice and simultaneously limiting the power of central authorities.

And also lowering the cost to entrenched elites of losing power.
2nd-Order effects...

C. All successful societies limit stakes of power by restricting scope of political authority against citizens’ interests. Two ways: General rules or Special privileges to the powerful. (Weingast 2013)

**Limited vs. Open Access** – Most LDCs limit access to markets and organizational forms privileged by law (e.g. limited liability – general vs special incorporation). Most DCs are open access.

- Limited access creates and distributes rent. Open access does not.
- Industrial policy will quickly degenerate in a limited access regime because low market disciplines.
- Limited access economies suffer higher informality, lower investment and innovation, and lower growth.
- Decentralization/federalism are incentive compatible ways to limit the power of different levels of gov’t.
2nd-Order effects...

This is the crux of the argument in favor of federal industrial policy.

Federal units can then compete over policy / Act as policy laboratories.
8. Conclusion

Decentralization & Federalism can contribute to the institutional changes that drive broad development transitions.

Decentralization is centrally implicated in key governance transformations: (i) increasing political competition, (ii) improving public accountability, (iii) decreasing corruption, (iv) enhancing political stability, (v) limiting government power, and (vi) promoting economic stability.
Conclusion...

Can be a key factor driving improvement or deterioration in all of these areas. **What’s the difference?**

If reform divides public resources and authority amongst independent units transparently, decentralization will provide an incentive-compatible means of limiting the power of government.

If independent govts must cooperate to achieve positive-sum outcomes, and this structure of incentives is replicated within political parties and the public administration, then decentralization will generate competitive incentives compatible with deepening democracy and strengthening the rule of law.
2nd-order effects can be very powerful. Such effects depend on “boring” things like efficient voter registration, robust campaign finance laws, transparent vote counting, etc to work.
Thank you
Why Viacha?
• Corrupt and corrupting mayor
• Ineffective municipal council
• Neutralized, corrupted oversight committee

→ Neither political nor social oversight of municipal activities.

Deeper causes
• A dominant firm – UCS/CBN brewery – was fiercely partisan. Monopsonistic provider of political finance to all parties. Dominated political party system and undermined opposition.
• Political party competition neutralized → Little political competition and no substantive political choice → Political apathy.
• Civil society divided between “white” city and indigenous countryside, itself divided between Machaqaas and the rest.
→ Widespread distrust; Episodic violence; No collective action
Why Charagua?

• Honest, hard-working mayor
• Representative, responsive municipal council
• Vigilant, independent oversight committee

Deeper causes

• Competitive local economy – pluralistic ranchers
• Open, competitive political system – open to new entrants
  → Political entrepreneurialism
  → Broad representation
• Highly structured and coherent civil society; High social capital

The APG is a civic organization rooted in Guaraní village traditions, which acts as ethnic advocate and regional self-government → high legitimacy and capacity to mobilize constituents’ opinions and efforts.
But political barons can manipulate under-institutionalized federal systems to extort fiscal transfers in exchange for political support for national policies. Hence Argentina’s 2001 economic crisis (Ardanaz et al. 2013).

→ This undermines investment and policy priorities, and cripples accountability nationwide.
Martinez-Vazquez & McNab (2003) argue that decentralization is simply a reorganization of existing public expenditure patterns. Altering who undertakes and executes such decisions may in the best case improve the quality and efficiency of government services, and hence of the economy as a whole, and so raise growth as such effects feed through to increased productivity. But such effects will take time to become noticeable.
In historical terms this is a huge reversal

Continuously increasing centralization over the past 15,000 years.

• **200,000 years ago**: Earliest anatomically modern humans lived in groups of *a few dozen* hunter-gatherers in Africa. Largely egalitarian and unorganized (Gronn 2010).
• **10-15,000 years ago**: Earliest agricultural communities exploit productivity gains from domestication of 10-100x → settled tribes of a few hundred, acquiring primitive organization and clear leaders.

• Farming improvements → villages grew into chiefdoms with populations in the thousands, centralized, hereditary leaderships, and multilevel bureaucracies.

• **6,000 years ago**: In river valleys of modern Egypt, Pakistan, India and Iraq, these societies became the world’s first cities.
• **5,700 years ago**: First states born in Mesopotamia, with populations of **50,000 or more**, many cities and villages, centralized decision-making and control of information, sophisticated bureaucracies and religious orders, systems of laws and judges, redistributive taxation, and a capital city. (Diamond 1998)

➤ Big advantages over smaller polities in the mobilization of resources and projection of power.

Then...

• Roman and Persian empires 2000 years ago.
• Medieval European kingdoms.
• Nation-states from about 17\textsuperscript{th} century onwards.
Increasing centralization is the defining characteristic of the past 10,000-15,000 years of human society

→ The rise of decentralization over the past half-century represents a unexpected historical reversal
Theoretical Arguments. What can decentralization do?

Arguments for. Decentralization can...
   i. improve information re: local wants and needs
   ii. increase citizen voice and participation
   iii. improve government accountability & responsiveness
   iv. deepen democracy
   v. strengthen individual liberties
   vi. improve economic performance
   vii. increase policy stability
   viii. reduce bureaucracy
   ix. decrease public spending
   x. decrease political tensions and the risk of civil war

Arguments against. Decentralization can...
   i. decrease efficiency in public goods production
   ii. decrease the quality of policy-making
   iii. increase graft and corruption
   iv. facilitate elite capture of government
   v. increase fiscal deficits and hence macroeconomic instability.
Why don’t we know more?

• Conceptual confusion
  → What is D? *Deconcentration, Delegation, Devolution, Privatization?*
  → Where is it implemented?

• Non-rigorous empirical basis
  → Qual: Small-N and large-X
  → Quant: Cross country studies make for bad comparisons – too much RHS uncontrolled variation.

• Wrong question: “Is D good or bad?”
The solution

Decentralization is the devolution by central government of specific functions (administrative, political and economic attributes) to democratic local governments that are independent of the center within a geographic and functional domain.

Empirical rigor – Large-N in one country + case studies. Blended quantitative-qualitative analysis.

→ Permits fine-grained, nuanced analysis.
→ Controls for external shocks, political regime, institutions, and other exogenous factors.

Right question: Why is the good good and the bad bad? “Outputs” of D = aggregate of local political & institutional dynamics, and so to understand decentralization we must first understand how LG works.
2. Decentralization in Bolivia (radical & sincere)

The Bolivian Decentralization Programme

• **Resource Allocation.** Transfers x2 → 20% national revenues. Later increased greatly. Allocation: political → per capita.

• **Local Public Services.** Education, health, irrigation, roads, sports and culture. Ownership of infrastructure and responsibility.

• **Oversight Committees** *(Comités de Vigilancia)* Alternative channel for popular demands. Composed of local, grass-roots groups that propose projects and oversee municipal expenditures.

• **Municipalization.** Municipalities expanded to include suburbs and rural catchments, and 198 new municipalities (out of 311 in all) were created.
Figure 2: Local v. Central Government Investment

- Hydrocarbons
- Industry
- Communications
- Multisectoral
- Water Mgt.
- Agriculture
- Energy
- Health
- Transport
- Water & San.
- Urban Dev't
- Education

% Total Investment

0% 5% 10% 15% 20% 25% 30% 35%
Central vs. Local Government Investment by Location

Central Government Investment, 1987-93

(highest 12 obs. dropped)

Local Government Investment by period, 1994-2007

2003-07

1997-2002

1994-96

Central Government Investment, 1987-93

(highest 12 obs. dropped)
Public Investment by Sector and Period, 1987-2007
Conclusions (i): 4 Stylized facts of Bolivian D

1. D shifted public investment from production to human capital formation and primary services.
2. This shift was driven by smaller, poorer, more rural municipalities.
3. Greater spatial equality as per capita criterion shifted resources massively towards smaller, poorer districts.
4. LG investments far more responsive to local needs than CG was before.
5. Conclusions

1. **Quant:** Where many firms interact with organized society, local policy is responsive to voters’ objective needs. These interactions are not only stat. sig., but also resolve competing priorities of different actors.

2. **Qual:**

**Charagua:** Heterogeneous local economy + highly organized society $\rightarrow$ political competition and entrepreneurialism $\rightarrow$ Effective LG

**Viacha:** Dominant firm acting as monopsonistic financier of parties + divided, suspicious society $\rightarrow$ Unaccountable, ineffective, corrupt LG
What are the fruits of Q2?

- **Depth and generality.** A nuanced set of relationships can be shown to hold not only in two municipalities, but for the whole of Bolivia.
- **Discrimination.** Theory does not tell us whether both causal factors are strictly needed to produce responsive government, or one alone can.
- Qualitative evidence provides too few degrees of freedom to distinguish between alternatives. Only quantitative evidence can distinguish.

  ![Diagram](image)

- **The answer?** Interaction of *both* factors is required for government responsiveness to local needs. Competing priorities of different actors are resolved through political competition. Different actors wield different amounts of influence over different issues, and voters get government to do what they need via their civic institutions, effectively countering the power of private firms and economic interests.
3. The Structure of Local Government

The Structure of Local Government

Local Constituency -> Policies -> Local Government Institutions

Local Government Institutions

Political Parties <-> Services <-> Civil Society

Political Parties -> Policies & Money -> Firms and Economic Interests

Local Government Institutions -> Information (Preferences) <-> Information (Feedback)

Local Government Institutions

Civil Society

Votes -> Local Constituency

Policies & Influence -> Firms and Economic Interests

Money -> Local Government Institutions

Information (Feedback) -> Local Government Institutions
Two channels to government responsiveness:

**Principal**
- Diverse, heterogeneous, local economy +
- Active society rich in organized groups →
  - Open, substantive political competition

**Alternative**
- Encompassing interest (firm, social group) →
  - Open, substantive competition of ideas and demands
The Question: Assume politicians are distributed normally by ability/effectiveness...

What are the characteristics of a political system that selects from L vs. H range?
5. A quantitative test: National evidence

For each sector I estimate:

\[ G_m = \alpha + \beta N_m + \gamma F_m + \delta C_m + \zeta N_m F_m + \eta N_m C_m + \theta F_m C_m + \lambda N_m F_m C_m + \xi Z_m + \varepsilon_m \]  

(1)

\( G = \) per capita investment in the given sector
\( N = \) initial stock of public goods (scalar)
\( F = \) # private sector firms (scalar or vector)
\( C = \) # civil society organizations (scalar)
\( Z = \) regional, demographic, economic, and institutional controls (vector)
Interaction terms are added gradually:
\[ G_m = \alpha + \beta N_m + \gamma F_m + \delta C_m + \xi Z_m + \varepsilon_m \]
\[ G_m = \alpha + \beta N_m + \gamma F_m + \delta C_m + \zeta N_m F_m + \eta N_m C_m + \xi Z_m + \varepsilon_m \]
\[ G_m = \alpha + \beta N_m + \gamma F_m + \delta C_m + \zeta N_m F_m + \eta N_m C_m + \theta F_m C_m + \xi Z_m + \varepsilon_m \]
\[ G_m = \alpha + \beta N_m + \gamma F_m + \delta C_m + \zeta N_m F_m + \eta N_m C_m + \theta F_m C_m + \lambda N_m F_m C_m + \xi Z_m + \varepsilon_m \]

...permitting a careful exploration of how firms and civic organizations affect government responsiveness.
## Results

**Education** (dependent variable: education investment (Bs.) per 1000 population)

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<tbody>
<tr>
<td><strong>Need Variable</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Illiteracy rate</td>
<td>496.7 *</td>
<td>319.2</td>
<td>2310.8 *</td>
<td>5351</td>
</tr>
<tr>
<td></td>
<td>(1.840)</td>
<td>(1.010)</td>
<td>(1.830)</td>
<td>(1.400)</td>
</tr>
<tr>
<td><strong>Firms and GROs</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>No. of firms</td>
<td>-258 ***</td>
<td>1867</td>
<td>2543.8</td>
<td>29361.4 ***</td>
</tr>
<tr>
<td></td>
<td>(-3.150)</td>
<td>(1.350)</td>
<td>(0.640)</td>
<td>(2.800)</td>
</tr>
<tr>
<td>No. of GROs (legally registered)</td>
<td>119.8 **</td>
<td>-13.1</td>
<td>216.4</td>
<td>-1718.1 ***</td>
</tr>
<tr>
<td></td>
<td>(2.100)</td>
<td>(-0.100)</td>
<td>(0.700)</td>
<td>(-3.020)</td>
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<tr>
<td><strong>Interaction Terms</strong></td>
<td></td>
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<tr>
<td>Illiteracy*Firms</td>
<td>-97.5</td>
<td>143.3</td>
<td>-7748 ***</td>
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<tr>
<td></td>
<td>(-1.010)</td>
<td>(0.610)</td>
<td>(-3.330)</td>
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<td>Illiteracy*GROs</td>
<td>5.11</td>
<td>-8.79</td>
<td>42.8</td>
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<tr>
<td></td>
<td>(1.280)</td>
<td>(-0.760)</td>
<td>(1.270)</td>
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<tr>
<td>Firms*GROs</td>
<td>12.7 **</td>
<td>23.8 *</td>
<td>-129.8 ***</td>
<td></td>
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<tr>
<td></td>
<td>(2.320)</td>
<td>(1.920)</td>
<td>(-3.240)</td>
<td></td>
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<tr>
<td># School attendance<em>Firms</em>GROs</td>
<td>-0.219 **</td>
<td>-0.433 *</td>
<td>35 # ***</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(-2.500)</td>
<td>(-1.720)</td>
<td>(3.650)</td>
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**Controls Omitted**

Interactions between private and civic groups are the single most important determinant of municipal responsiveness. → **Large real effects.**

2003-07: 1 s.d. increase in illiteracy, given dense firm-GRO interactions → Bs. 998,795 investment per thousand. Independent effects of GROs & firms on need-responsiveness are small and nil. Need variable on its own becomes insignificant.
Model 3-5 are full test of theory: Urban development investment is regressive in terms of need, mainly because firms want it so. Firms press municipalities for regressive investment, but civic groups counteract most of that through their interactions with firms.
Firms and civic organizations have different preferences. Primary way they affect local policy is via interactions with each other → unambiguous collective preference for more health investment in 2 of 3 periods. Interaction effects > residual impact of need variable. → Whatever else makes investment sensitive to health needs is less important than interaction of economic and civic actors through the political system.

| Health (dependent variable: health investment (Bs.) per 1000 population) |
|-------------------------------|---|---|---|---|---|
|                               | Base | 2   | 3   | 4       | 5       |
| Need Variable                 |       |     |     |         |         |
| Child malnutrition rate (total) | 289.5 * | 288.2 * | 359.3 ** | -183 | -2687.4 ** |
|                               | (1.840) | (1.850) | (1.990) | (-0.530) | (-2.070) |
| Firms and GROs                |       |     |     |         |         |
| No. of firms                  | -54.1 | -260.5 | 833.5 | 4250.9 | -29.4 * |
|                               | (-1.300) | (-1.000) | (0.850) | (1.140) | (-1.770) |
| No. of GROs (legally registered) | 45.9 * | 26.7 | 117.8 | 41.1 | -1337.9 * |
|                               | (1.720) | (0.990) | (1.520) | (0.210) | (-1.860) |
| Interaction Terms             |       |     |     |         |         |
| Malnutrition*Firms            | -34   | -210.6 | 48.1 *** |         |         |
|                               | (-1.120) | (-1.180) | (3.460) |         |         |
| Malnutrition*GROs             | -2.88 | 0.106 | 37.3 * |         |         |
|                               | (-1.220) | (0.020) | (1.840) |         |         |
| Firms*GROs                    | 0.00828 ** | -3.19 | -0.28 * | 0.0834 ** |
|                               | (2.100) | (-1.320) | (-1.730) | (2.220) |
| Malnutrition*Firms*GROs       | 0.000716 *** | 0.0156 * | 0.00133 |         |
|                               | (3.490) | (1.770) | (1.020) |         |

**Controls Omitted**
Conclusion (ii): Determinants of LG Responsiveness

• Neither economic interests nor social forces alone can explain Viacha/Charagua or quantitative results (311 muns.)
• Interaction of both factors explains outcomes
• Politics appears to be endogenous to the interaction of economic actors and civic organizations
How to study comparative institutional reform?

Class of phenomena where rules, complex organizations, and social norms interact to produce outcomes.

- 1-country, large-N study
  - Quantitative + Qualitative methods
- Understand in depth what happened in each country before comparing amongst them.