

Federalism: A Constitutional Perspective

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One of the key decisions that a community must face when writing its constitution is whether to structure itself as a federation or not. Many benefits have been claimed for federalist institutions. Given these it is somewhat paradoxical that we observe so few countries in the world, which possess all of the attributes of a strong federalist structure. There are two possible explanations for this paradox. First, there may also be many disadvantages associated with federalism, so many that for most countries the disadvantages outweigh the advantages. Thus, full-blown federalism may be rare, because in fact it is undesirable.

The second possible explanation for federalism's rarity is that it is somehow inherently unstable. When it is chosen it fails to survive, not because of any fundamental difficulty in the outcomes it produces, but because of the existence of forces in a democracy, which undermine it. This paper will argue that it is the latter characteristic of federalism, which accounts for its rarity.

We proceed as follows. We begin with a discussion of the advantages of federalist institutions in a democracy. Following that we take up the issue of how one might go about designing these institutions from a constitutional perspective. In Section III, we turn to the issue of the disadvantages of federalism. This discussion, like that of the advantages of federalism, confines itself to the theoretical objections that have been raised against federalism. As always, the question of whether the advantages of a set of institutions outweigh their disadvantages must be settled empirically. The empirical literature on

federalism, as it pertains to this question, is discussed in Section IV. In Section V I attempt to make the point that direct democracy is a natural accompaniment to federalism, and that both are likely to function better if they are combined. Section VI addresses the issue of how one can preserve federalist institutions from being absorbed and corrupted by the central government. The chapter closes with a brief set of conclusions.

I. Why Federalism?

The normative rationale for the state in the public choice literature is that it is a low transaction cost institution for eliminating certain market failures and thereby achieving Pareto optimality (Mueller, 2003, Ch. 2). The two main categories of market failures in the public economics literature are public goods and externalities. The definitions of both implicitly introduce a spatial dimension to the polity. Once a public good is provided to one member of the community, it must (may) be provided at zero marginal cost to all other members. Examples of public goods are police protection (where the verb "must" is appropriate), and a bridge (where the verb "may" is appropriate). A police force only protects the citizens within a circumscribed area, however, and a bridge is of value only to those living near enough to wish to cross it. Different public goods can be consumed by different geographically dispersed groups – national defense by the entire nation, fire protection only by those within a small radius of a fire station.

The same is true for externalities. The pollution spewed into a lake by a factory located on its shores harms only those with access to the lake. Global warming affects everyone on the face of the earth. Thus, the geographic dimensions of the spillovers from public goods and externalities lead naturally to the recommendation that different sets of governmental institutions be charged with the responsibility for dealing with different sets of

market failures (Oates, 1972, 1999). In a democracy, such an organizational structure might take one of three forms:

(1) A unitary, decentralized state with regional and local departments responsible to the central government, which in turn is responsible to the citizens. Elections serve the purpose of deciding the identities of the officials in the central government, they in turn appoint officials lower down in the administrative bureaucracy.

(2) A federalist structure. Several levels of government exist, say, central, regional and local, with each level having its own separately elected democratic bodies, and with each responsible for the efficient resolution of a particular set of market failures.

(3) A confederate structure. At the most central level of government, citizens are not represented directly, but only indirectly through *national* governments. These national governments can in turn be organized as either unitary states or federations. In this paper we shall not consider the possibility of a confederation any further.¹

In principle, a single, unitary state could provide all public goods and optimally deal with all other market failures even in a geographically very large and diverse country. This would be quite easy, for example, if the preferences of individuals for regional and local public goods were the same in all parts of the country. The level of police protection and trash collection that was optimal in one local community would then be optimal in all, and the central government would have a fairly easy time determining the levels of regional and local government services that were optimal. Even with substantial preference heterogeneity across communities, a unitary state could be optimal, *if* there were zero transaction costs to gathering information on individual preferences for regional and local public goods. In any situation that is not Pareto optimal, it is possible to make some voters somewhere in the country better off without making anyone else worse off. Vote maximizing politicians in a

unitary state would not pass up such a costless opportunity to win more votes. But the zero transaction costs assumption is untenable in a large and diverse country. The costs of determining the preferences of citizens in each local jurisdiction for trash collection, police protection and so on through a national election would be enormous, even in a country with a fairly small and homogeneous population like Sweden. Thus, the normative justification for federalism – as for the state itself – becomes that of minimizing the transaction costs of gathering information on voter preferences for public services (Mueller, 2003, Ch. 10). Federalism becomes the optimal institutional structure for any country of moderate size and preference heterogeneity.

II. How Federalism?

Once the decision has been made to have a federalist system, the next question concerns its optimal design. How many levels of government should there be? What should be the boundaries at each lower level? What expenditure responsibilities should be assigned to each level? What revenue sources should be assigned to each level? What should be the form of representative government at each level? These are difficult and interrelated questions, and no single set of answers will be optimal for all countries. Again the answers will depend in part on the nature and scale of transaction costs.

Quite possibly no two market failures have exactly the same geographic spillovers. A playground serves a small neighborhood, a fire station a somewhat larger area, a police station a perhaps still larger area. Although defining a separate democratic government for each market failure would be a possible response to these differences in geographic spillovers, the number of governments needed would become intractably large. A

¹ See, however, Mueller (1996, Ch. 21), and Blankart and Mueller (2004).

compromise becomes optimal with several government services assigned to each level of government, no two of which, perhaps, having identically contiguous spillovers.²

The assignment of expenditure responsibilities ought to be made on the basis of the dimensions of geographic spillovers of each market failure addressed by the state. Once responsibilities for expenditures have been assigned, the next step is to assign revenue sources. Since the main purpose for creating a federalist state is to facilitate the revelation of preferences for public services, the choice of revenue sources should be made with this same goal in mind. The most obvious way to do this is to establish the Wicksellian connection – each public expenditure should be coupled with a tax to finance it, so that the voter knows exactly how much she is paying for it (Wicksell, 1896). Establishing such a link will make it easier for the voter to decide whether the government is providing the optimal amount of the public service. Establishing such a link in a federalist system implies, furthermore, that each level of government have the fiscal capacity to finance all of its expenditure obligations, so that voters at every level of government can assess the performance of their elected representatives at the level in question with respect to the amounts and qualities of government services they are getting for the taxes that they are paying.

A further implication is that a federalist state should make limited use of intergovernmental grants. Such grants make it difficult for voters to assess the costs of different programs. If, for example, a third of a local government's budget is funded by a grant from the central government, a citizen may mistakenly believe that her taxes at the local level pay for all of its programs. Underestimating the true costs of the local programs she may favor greater expenditures by the local government than are optimal. Even if she recognizes that some of the local budget is financed by the central government and thus that

² See, Tullock (1969), Oates (1972, 1999), Mueller (1996, Ch. 7; 2003, Ch. 10), and Inman and Rubinfeld (1997).

her taxes to the central government are paying for local programs, it will be difficult for her to assess how much of her tax payments to the central government are going to for the local government's expenditures. Thus, at a minimum, grants from the central government to local governments reduce citizens' ability to monitor and thus to control their representatives in government.

Thus, in an ideal federalist system, every person who benefits from the programs of a given political unit will pay taxes to that unit to pay for the benefits, and will be a citizen of it, and able to select the persons or parties that decide on the government's tax and expenditure programs.

III. Problems of Federalism

Several problems can arise in a federalist state that must be taken into consideration in the design of such a state and in its operation. In this section these problems are briefly discussed. In the next section we examine the empirical literature that tries to measure just how serious each potential problem is.

A. Fiscal Inequality

If public goods are normal goods, then the quantity demanded of them increases with the income of the community. If the quantity demanded is determined by the median voter, then it increases with the income of this voter. Communities with high incomes will demand and presumably be supplied greater quantities of public goods than low-income communities. Such inequalities may be deemed unacceptable when they appear for public programs like education. That is, everyone in a nation may agree that every child should be able to obtain an education of a minimum quality. If some communities are too poor to provide such an education, a Pareto improvement may be forthcoming by transferring funds from members of

rich communities to the poorer communities so as to increase the capacity of the poorer communities to finance these minimum levels of public services.³

B. Geographic Externalities

The consumption or production activities of one community may have positive or negative external effects on another. If, for example, an upstream community dumps sewage into a river, it may adversely affect a downstream community. Such externalities can in general be resolved in a Pareto optimal fashion by Coasian bargaining between the communities. The downstream community offers the upstream community a bribe to reduce the amount of sewage dumped into the river. Intergovernmental grants are again required to achieve a Pareto optimal allocation of resources, but now they are between governments at a local or regional level, rather than from the central government to lower levels. Only in the case where the number of externalities across local communities became so large and complex as to make Coasian bargaining among communities prohibitively costly would intervention and grants from the central government become optimal.

C. Migration Externalities

When local governments offer different bundles of tax and expenditure combinations, individuals may respond to these differences by migrating to those communities, which provide the best match for their preferences. Such migration can improve allocative efficiency à la Tiebout (1956), and is thus an important justification for creating a federalist system, but it can also bring about certain externalities, which lead to Pareto inefficiencies. These externalities are of three types: crowding, fiscal capacity and redistributive externalities.

³ The classic reference on this is Buchanan (1950). See also Chernick (1979).

1. Crowding and fiscal capacity externalities

When someone moves from community A to B , she considers only her level of utility in the two communities. She moves if the expected utility in A is higher than in B . Her movement can adversely affect the existing residents in A , however, by leading to overcrowding in that community. Her movement could, alternatively or in addition, have an adverse effect on the residents of B by lowering its tax base. There are two possible ways to avoid these negative externalities from migration. One option again relies on the central government's power to tax and transfer wealth. It can levy taxes on community A and transfer funds to B in sufficient quantities to produce the optimal distribution of population between the two communities. The alternative solution vests the power to tax and subsidize with the local communities. For example, community A could effectively tax immigration into it by making large charges for new water and sewage hookups, levying high taxes on new construction sites and so on.⁴

2. Redistributive externalities

Assume that everyone in a community of nine has the same utility function U , $U = a X^a G^b$, where X is the quantity of a composite private good and G is the quantity of a pure public good. Let the community of nine be divided into three smaller communities, A , B and C , each of which contains three people. Assume further that three of the nine people have incomes of 100, three have incomes of 200, and the remaining three have incomes of 300. Now assume that the three smaller communities initially contain one person with an income of 100, another with an income of 200 and the third person has an income of 300. If the quantity of G in each community is chosen using the simple majority rule, then the same

quantity will be chosen in each community, namely the quantity favored by the median voter with an income of 200. If the individuals are allowed to move between the communities, a resorting can be expected with all persons with an income of 300 in one community, all with an income of 200 in the second, and the three with an income of 100 in the remaining community. It can easily be shown that such a resorting will result in a Pareto improvement in the allocation of resources in the three communities (Mueller, 2003, Ch. 9). Nevertheless, the three individuals with incomes of 100 will be consuming less of the public good than before and are likely to be made worse off by the resorting. Thus, a situation that was possibly deemed acceptable on equity grounds in the initial situation might become unacceptable because of sorting by income.

IV. Empirical Evidence related to Federalism

A considerable amount of research has tried to measure the extent to which the hypothetical problems listed above exist in practice. In this section we review this evidence.

A. Federalism and Allocative Efficiency

1. The Flypaper Effect

Perhaps no single hypothesis in the literature on federalism has more empirical support than the prediction that intergovernmental grants lead to an expansion of the public sector. In a literature dating back some forty years countless studies have established that a local government generally spends a far larger fraction of an unconditional grant from a higher level of government than its citizens would appear to consider optimal.⁵ Moreover,

⁴ For further discussion, see Mueller (2003, Ch. 9).

⁵ Even the number of surveys of this literature is by now large, see, for example, Gramlich (1977), Inman (1979), Fisher (1982), Heyndels and Smolders (1994, 1995), Hines and Thaler (1995), Becker (1996), and Bailey and Connolly (1998). For a recent study identifying a substantial flypaper effect in Taiwan, see Chu (2003). Gemmell, Morrissey and Pinar (2002) also present recent evidence for the UK of the flypaper effect.

the additional amounts spent often exceed the optimal amounts by factors of three, four and more. As always when a controversial hypothesis receives empirical support, the findings of the flypaper literature have been challenged.⁶ But the overwhelming weight of the evidence still supports the conclusion that the use of block intergovernmental grants leads to an expansion of the size of local government budgets beyond that favored by citizens of the local community.

2. Government Size

Taking into account only the flypaper effect, one might predict that the size of the total government sector would be larger in a federalist system than in a centralized one. Offsetting the effects of intergovernmental grants, which can conceal government expenditures from the view of citizens, are the effects of greater overall transparency in a federalist system, competition across governments at a given level, and therefore greater overall accountability of elected officials in a federalist system. Once again the question of whether the government sector should be larger or smaller in a federalist system requires an empirical answer.

In a recent study, Gemmell, Morrissey and Pinar (2002) have shown how the creation of a close link between taxes and expenditures at the local level of government can increase voter awareness of the costs of government services and thereby greater government accountability. This happened in Great Britain in 1990 when the highly controversial poll (head) tax was introduced.

Unfortunately, empirically identifying a causal link between the full set of federalist institutions and governmental efficiency and accountability is difficult owing to the scant number of countries that are true federalisms. To my mind there are only five true federalist

⁶ For two recent challenges, see Becker (1996) and Worthington and Dallery (1999).

states in the world – Australia, Brazil, Canada, Switzerland and the United States. Given its different state of development, Brazil is difficult to compare with the others. Within the set of rich, developed countries of the world, Australia, Switzerland and the United States have somewhat smaller government sectors – that is under 40 percent of GDP. Canada's government sector is about average in size (around 50 percent of GDP).

Most studies, which claim to test for the impact of federalism on government size, compute an index of decentralization, and test to see whether government size is inversely related to decentralization. In general it has not been found to be significantly related to measures of decentralization.⁷ Recent work by Jonathan Rodden, however, has established a significant relationship between the strength of a country's federalist institutions and various measures of government performance. His work reveals quite clearly that the full benefits from a federalist structure can only be obtained when all of the components of a strong federalist structure are present. In countries in which lower level governments have the authority to set both the levels of their expenditures and their taxes, government deficits are smaller as is total government spending. When local governments are heavily dependent on grants from the central government, they are more prone to run deficits and the country has a higher rate of inflation.⁸

Rodden's results linking the size of intergovernmental grants to government deficits reinforces the findings from studies of the flypaper effect of intergovernmental grants. Not only are local governments prone to spend more money when they receive grants from higher levels of government, but they are also more prone to run deficits in the expectation that the central government will bail them out. Limiting intergovernmental grants to those necessary for achieving intergovernmental fiscal equivalence would produce both greater accountability

⁷ See, Oates's (1988) survey.

of local governments and greater intergovernmental competition and thereby better local governmental outcomes.⁹

B. The Effects of Migration

Migration in a federalist system should have the positive effect of bringing about a better match between citizen preferences for local public goods and taxes, but may have the negative side effects of producing crowding in particularly attractive communities, and may worsen the effects of income inequality by resorting citizens by income. Casual observation suggests that migration into some communities exceeds the optimal level producing pollution, traffic congestion and related problems. Here the world's largest cities – Buenos Aires, London, Los Angeles, Mexico City – come readily to mind. In surveys of the best places in the world to live, these once great cities now generally are placed behind smaller cities like Zurich, Vancouver and Vienna. More systematic evidence exists related to the other two consequences of migration.

For the Tiebout process to work, there must be an array of alternative communities from which a citizen can choose, and sufficiently low mobility costs to make a move to a “better community” welfare enhancing. These conditions are more likely to be fulfilled in large urban areas than in small rural ones, as a citizen can change local communities without changing jobs or moving a great distance from family and friends. One expects to find a greater alignment of preferences for local government programs in large urban communities, therefore. This prediction has been confirmed in several studies, which report lower levels of

⁸ See, Rodden (2001, 2002, 2003) and Rodden and Wibbels (2002). For additional recent evidence of an inverse relationship between federalist institutions and government size, see Vaubel (1996), and Persson and Tabellini (2003, Table 3.1, p. 40).

⁹ For additional discussion of the problem of soft budget constraints and local government bailouts, see von Hagen and Eichengreen (1996), and von Hagen and Dahlberg (2004). Careaga and Weingast (2003) provide a case study of Mexico illustrating how intergovernmental grants and soft budget constraints produce fiscal laxity by local governments.

dispersion of voter demands for education and other local expenditures in large urban communities (Munley, 1982; Gramlich and Rubinfeld, 1982). Gramlich and Rubinfeld (1982) also report a higher percentage of citizens in the Detroit metropolitan area who were satisfied with the level of expenditures of their local government than for citizens in rural areas of Michigan.

Numerous studies have reported that citizens' decisions to move from a community are affected by the government expenditures and taxes in both the community that they are leaving and the community into which they are moving.¹⁰ Perceptions of problems in a community – a signal of a governmental failure – also causes people to move (Orbell and Uno, 1972). Thus, the existence of unhappiness over expenditure/tax combinations at the local level, or over the results of these expenditures, does lead to migration to other communities, when more desirable communities exist and can be entered at relatively low cost.

There is also considerable evidence that migration resorts people into communities of more homogeneous incomes. The most ambitious and convincing study of this phenomenon is Gary Miller's (1981) study of the effects of migration between 1950 and 1970 in Los Angeles County. Local communities were significantly more homogeneous in terms of both income and race in 1970 than in 1950, and this was particularly true for communities that came into existence over the 20-year period. Corroborative evidence for the Boston area has been supplied by Grubb (1982). Recent results by Rhode and Strumpf (2000) indicating *decreasing* heterogeneity across communities run counter to what one expects from the work of Miller, Grubb and others, however.

¹⁰ See, Gramlich and Laren (1984), Blank (1988), Cebula and Koch (1989), Cebula (1990, 1991). The literature has been surveyed by Cebula (1979), Cebula and Kafoglis (1986) and Dowding, John, and Biggs (1994).

C. Mimicking Behavior

A closer alignment between citizen preferences and government tax/expenditure programs can evolve over time even when citizens do not migrate from one community to another, if local governments *imitate* the policies of their neighbors. Ladd (1992), Case, Rosen, and Hines (1993), and Besley and Case (1995) provide evidence implying local governmental imitating of neighboring governments' policies in the United States. Similar findings for Belgium have been reported by Heyndels and Vuchelen (1998), for Germany by Büttner (1999, 2001), and for Switzerland by Schaltegger and Küttel (2002). This evidence of imitation can be interpreted in two ways. First, it can imply that a successful innovation in the public sector by one local government is copied by others, as for example a new source of tax revenue. The competitive pressure to win elections within each polity leads politicians to imitate the successful policies of their neighboring governments. The second interpretation is that the citizens observe the policies of neighboring communities and demand similar policies from their elected representatives. These two interpretations obviously complement one another and suggest that the multitude of different governments and different sets of governmental outcomes in a federalist state leads to the same benefits from competition that one expects in markets with large numbers of sellers.

V. Federalism and Direct Democracy

One expects that the kinds of benefits from competition across governments described in the previous subsection will be greater, the more effective the democratic institutions of a country are. The easier it is for voters to express their preferences and thereby influence their government, the closer the correspondence between a citizen's preferences and government policies. This reasoning suggests that democracy will function best when voters can express

their preferences directly. Direct democracy is the oldest form of democratic government, and by some is still regarded as the *best* form of government.

Direct democracy of the type where all citizens meet to debate and decide the issues can only take place in communities of small size. Thus, there is a link between direct democracy and federalism. The town-meeting form of direct democracy is *only possible* if the polity has been broken up into politically autonomous units with some being of, say, no more than five or ten thousand inhabitants, so that all citizens physically can assemble together. Thus, town-meeting democracy is only feasible in a federalist system.

When most people speak of direct democracy today, they do not mean town-meetings, but rather citizen initiatives and referenda.¹¹ Although these can in principle be held in countries of any size, when placing an initiative on a ballot requires gathering the signatures of a substantial fraction of the population, as say ten percent, it is in general infeasible to successfully organize signature drives in very large polities. Thus, this form of direct democracy is more likely to be effective in a federalist system.

The number of truly federalist countries in the world is small and the number, which makes much use of institutions of direct democracy, is smaller still. In this section we briefly review the evidence for the two countries making the most use of direct democracy – Switzerland and the United States.

A. Direct Democracy in Switzerland

Much of the public choice literature suggests that the government sector in a democracy will be bigger than is optimal from the perspective of the citizenry. Thus, the more responsive governments are to the preferences of the citizens, the smaller the expected

¹¹ For a discussion of the various forms of referenda and initiatives that are possible, see Mueller (1996, Ch. 12).

size of the government sector. Evidence from the public choice literature implies both a closer fit of government policies to citizens' preferences and overall smaller-sized governments when institutions of direct democracy are present. Several studies have confirmed this result. One of the earliest was that of Pommerehne and Schneider (1982). They first estimated the parameters of a standard median-voter model of the demand for government services. They then used the estimated parameters from this model to predict the levels of government in several categories in communities that elected representatives. They found actual expenditures in communities with representative democracy exceeded predicted expenditures based on the estimates from communities with town-meeting forms of direct democracy in *every* category. Total government spending was 28 percent higher than predicted. Moreover, within the group of communities using representative democracy, spending was lower where citizen initiatives were possible than where they were not possible. Several other studies for Switzerland have confirmed the Pommerehne and Schneider findings.¹²

Using data for Switzerland Schaltegger and Küttel (2002) find that the strength of democratic institutions in a local community, as measured by the degree of direct democracy, is inversely related to the proclivity of its government imitating the policies of neighboring governments. When citizens can effectively express their preferences directly, their governments do not have to take their signals from neighboring governments. Other indexes of government performance like GDP per capita also indicate superior performance (that is higher incomes) in communities with direct democracy (Feld and Savioz, 1997; Freitag and Vatter, 2000). Swiss citizens also report being *happier* in communities that make greater use of the institutions of direct democracy (Frey and Stutzer, 2000).

¹² See, Pommerehne (1978), Pommerehne and Schneider (1983), Feld and Kirchgässner (1999), and Feld and Matsusaka (2000).

B. The United States

Twenty states and more than 80 cities in the United States allow citizens to call initiatives. Initiatives have been used in some states for more than a century. These data have recently been utilized by John Matsusaka (2003) to examine the effects of citizen initiatives on democratic outcomes. His study confirms the findings of the studies for Switzerland. The availability and use of citizen initiatives leads to a closer alignment of governmental policies to citizen preferences. In this section we briefly describe and comment on his main findings.

Finding 1. Over the period 1970-1999 state and local government expenditures in the United States were lower in states that allowed citizens to call initiatives than in other states. The availability of the initiative option reduced state and local government expenditures by four percent, roughly \$468 for a family of four (Matsusaka, 2003, Ch. 3).

Finding 2. Initiatives lead to a greater decentralization of government expenditures. Local governments account for a greater fraction of total expenditures in states with initiatives. Cities, which can call initiatives, spend *more* money than cities without this option. Thus, citizen initiatives change the composition of government spending as well as its size. Indeed, the decentralization effect of initiatives is greater than their effect on the size of the budget (Matsusaka, 2003, Ch. 4).

Finding 3. Initiatives alter the composition of revenue sources for state and local governments. Cities that allow initiatives make greater use of fees for government services and less use of taxes (Matsusaka, 2003, Ch. 5). For me this is a most interesting finding, since I have recently advocated, in the context of a constitutional reform in Sweden, coupling the introduction of a federalist system with a greater use of user fees to finance local governmental expenditures (Mueller, 2004; Mueller and Uddhammar, 2004). My argument

for doing so was that user fees made it easier for a citizen to judge the costs of a public service and thus lead to better informed citizens and, therefore, to a better match between citizen preferences and governmental policies. Matsusaka's findings imply that citizens themselves favor the greater transparency of user fees over taxes, and opt for them, if given the opportunity.

Finding 4. The results of polls indicate that the differences in outcomes between states with initiatives and those without are in the direction of what citizens want. During the period 1972-95 citizens in the United States favored reductions in government expenditures and a greater reliance on user fees (Matsusaka, 2003, Ch. 6). Initiatives have moved governmental policies toward those favored by the majority of citizens.

Additional support for this finding is provided Elisabeth Gerber (1999) in her study of referenda and initiatives. She finds that *citizen groups* have some success in getting new legislation through the initiative process, but not *economic interest groups*, which, presumably, are less representative of the majority of citizens' views. Economic interest groups are successful only in sometimes blocking new legislation through initiatives.¹³

Of particular interest also is the finding that citizens are most content with the policies provided by their local governments, least satisfied by what the central government does. I doubt very much that one would come up with a similar finding from polls conducted in, say, Sweden or Austria – countries where authority for decision-making or taxation are concentrated at the central level. Citizens in these countries do not perceive of their local governments as the main determinants of the bundles of expenditures and taxes that they experience. Satisfaction or dissatisfaction must be directed to the highest level of

¹³ For further evidence that institutions of direct democracy in the United States have moved government policies closer to those favored by the citizens, and reduced the sizes of government budgets, see Santerre (1986, 1989), and Kiewiet and Szakaly (1996).

government. That the highest level of government is the one least liked in America is in itself a great endorsement for federalism.

Finding 5. In the period from 1902-1942, states with an initiative option spent eight percent *more* on government goods and service than did states without the initiative (Matsusaka, 2003, Ch. 7). The massive shift in population from rural areas into the cities led to an increase in the demand for government services such as education, sanitation and other public goods supplied to urban dwellers. In part, because of over-representation of rural areas in state legislatures, state and local governments were slow to respond to the shift in demand for government services over the first half of the 20th century. In states where citizens could call initiatives, citizens were able to correct the mistakes of their representatives. This finding of Matsusaka indicates that initiatives do not necessarily result in smaller public sectors. The primary effect of initiatives is to bring governmental policies into closer alignment with citizen preferences. To the extent that representative democracy leads to government sectors, which are too large from the perspective of citizens – as much of the public choice literature implies – then initiatives will reduce government size. When, however, government budgets are too small from the perspective of a majority of voters, the initiative will increase the size of the government sector as occurred in the United States during the first half of the 20th century.

The literature on the effects of direct democracy in Switzerland and the United States reviewed in this section paints a remarkably consistent picture. When citizens can decide governmental policies directly, these policies shift in the direction of those favored by a majority of the electorate. Direct democracy leads to a closer alignment of government policies and citizen preferences. Since initiatives are easier to call in small polities than in large ones, and town-meeting democracy is only feasible in small communities, the literature on direct democracy's effects indirectly also argues for the introduction of a federalist

system. The ideal governmental structure for representing citizen preferences would appear to be a federalist system with healthy doses of direct democracy.

VI. The Problem of Centralization

In 1929, the federal government accounted for 30 percent of total government expenditures in the United States, today it accounts for some 60 percent of revenues and expenditures (*Statistical Abstract*, 2002, Tables 414, 449). In 1950 the central government raised roughly 60 percent of all tax revenue in *Federal Republic of Germany*, today it raises over 90 percent (Blankart, 2000, p. 31). Similar processes of centralization occurred during the 20th centuries in the federal states of Australia and Canada (Head, 1983; Grossman and West, 1994). So pervasive is the process of centralization even within federalist states that it has come to be referred to as *Popitz's law*, named after the German economist who in the early part of the 20th century already remarked on the tendency toward centralization in state revenue sources and expenditures (Blankart, 2000). Thus, any country, which opts for a federalist structure to benefit from the advantages of decentralization, must also determine how it intends to protect any degree of decentralization originally defined in the constitution from the workings of Popitz's law.¹⁴

One strategy for preventing the central government from usurping the tax and expenditure authorities of lower levels of government is to assign explicitly in the constitution specific responsibilities for certain activities to each level of government, and charge either a specially created federalist court or the regular courts with ensuring that each level of government restricts itself to the set of activities assigned to it (Mueller, 1996, Ch. 6). The United States' Constitution contains such language and its presence in the Constitution

¹⁴ The extent of this challenge has been stressed by many writers, see in particular Riker (1964), Weingast (1995, 2004), and Filippov, Ordeshook and Shvetsova (2003).

plus the Supreme Court's willingness to enforce this provision undoubtedly helps to explain why the central government's share of total government expenditures was so small in 1929. The Supreme Court's capitulation in the 1930s to Franklin Roosevelt's pressure to allow the federal government to expand its domain explains the relative growth of the central government in the United States since that time. The U.S. experience indicates that the assignment of specific functions in the constitution can help to avoid the enforcement of Popitz's law – *if the language of the law is defended by the judicial system.* The U.S. experience further illustrates that without the support of the judiciary, the language of the constitution alone will not deter a central government bent on expanding its domain.

Italy's experience over the latter part of the 20th century provides an additional example of how constitutional and legal restrictions on the central government can prevent it from encroaching on the authority of lower levels of government, when backed up by the judiciary. Despite the fact that Italy is more of an example of a unitary state than a true federalism, the assignment of specific authorities to regional governments in the constitution in combination with the willingness of Italy's Constitutional Court to enforce this article and subsequent acts of the parliament guaranteeing the regional governments' authority has succeeded in maintaining a certain degree of decentralization in Italy's fiscal structure.¹⁵

In Austria, Germany, and Switzerland, the legislature's second chamber is filled by representatives of the regional governments, the Länder. The claim has been sometimes made that this system of representation helps preserve the federalist integrity of these states, because the representatives of the regional governments resist any efforts by the central government to encroach upon their expenditure or tax authorities. The history of Germany over the last 50 years clearly contradicts this claim, and the same can be said for Austria (Blankart, 2000).

All citizens dislike taxes and appreciate the benefits that flow from government outlays. All vote-maximizing politicians would rather raise expenditures than taxes. This set of preferences explains why government deficits are far more common than government surpluses, and the growth in the centralization of tax revenues that took place in Germany over the last half century. The *Länder* governments were willing to hand over taxation powers to the central government so as to avoid having to raise taxes to finance the substantial growth in state expenditures that occurred over this period. The *Länder* governments effectively formed a cartel amongst themselves and the central government to hand over taxation authority and expand expenditures (Blankart, 2000). Grossman and West (1994) explain the growth in size of the state sector in Canada over the last century as a result of the same sort of cartel behavior among its regional governments, the ten provinces.

Why has the same sort of centralization of government expenditures not taken place also in Switzerland? Indeed, the fraction of total tax revenue raised by the central government in Switzerland actually *fell* from roughly 60 percent as in Germany in 1950 to under 50 percent by 1995 (Blankart, 2000, p. 31). Switzerland's federalist structure appears to have been protected not so much by its judiciary, but by its citizens exercising their constitutional right to call referenda on governmental actions. Once again we observe the important symbiosis between federalism and direct democracy. One additional way to try to protect the decentralized nature of a federalist state is to combine it with institutions of direct democracy.

The case of Switzerland provides further evidence in support of Weingast's (1995) theory of "market-preserving federalism." According to Weingast, the necessary conditions to preserve federalism are not simply a well-designed set of institutions imbedded in a constitution. "Limited government ...depends on how citizens react to a potential violation

¹⁵ See discussion by Breton and Fraschini (2003).

of that constraint. The ultimate sanction on a government is the withdrawal of support by a sufficient proportion of its citizens so that the government cannot survive” (Weingast, 1995, p. 26). Weingast illustrates his thesis with the examples of 18th century Britain and 19th United States. In both cases the citizens were united in wishing to constrain the activities of the central government, and acted to do so. Referenda lower the transaction costs of constraining government and thereby facilitate achieving this goal – if the citizens want it.¹⁶

Preventing over centralization is one of the most difficult challenges facing the writers of a constitution. In this section I have suggested two institutional protections against Popitz’s law – language in the constitution assigning authorities to each level of government backed by judicial enforcement, and referenda and citizen initiatives. ugh I am more optimistic than they about such constitutional devices for avoiding Popitz’s law, one should not underestimate the difficulty of accomplishing this task. This goal must be uppermost in the minds of those who delineate a federalist system in a new constitution.

VII. Conclusions

A federalist governmental structure can make governments more responsive to citizens’ wishes thereby bringing about a closer alignment between citizens’ preferences and government policies. The empirical literature suggests that this alignment is particularly close when the institutions of federalism are combined with those of direct democracy. Only a handful of countries in the world have strong federalist systems in which the elected governments at each level can determine both the size and composition of their expenditures and the constellation of taxes and fees that finances them. Only two of these countries – Switzerland and the United States – combine federalism with direct democracy, and in the

¹⁶ Both Weingast and Filippov, Ordeshook and Shvetsova (2003) emphasize the role of a constitution as a “coordinating device” in preserving the integrity of a federalist system.

case of the United States this occurs in less than one half of the states. The potential benefits from federalism go unrealized in most countries, including those like Austria and Germany that call themselves federal republics.

The literature reviewed in this essay indicates that federalism comes at a price. Perhaps its largest cost is borne by the citizenry who have to participate in elections at several levels of government. This burden becomes particularly large where federalism is combined with direct democracy. But the evidence from numerous studies from Switzerland and the United States indicates that the benefits from a greater alignment of citizen preferences and government policies outweigh the costs.

Federalism can impose additional costs on communities where the migration of citizens creates negative externalities or tax competition erodes government revenue sources. There is no evidence, however, that these costs outweigh the benefits from mobility and tax competition. The benefits from mobility come from increasing the degree of homogeneity of preferences in local communities thereby narrowing the gap between what voters want from government and what they get. The benefits from tax competition come through the greater efficiency in the provision of government services that competition produces.

Thus, we conclude from this review of the empirical literature on federalism that it can be an attractive option for most countries seeking more responsive and efficient democratic institutions. The challenge these countries face is to design these institutions in such a way so as to achieve their maximum potential benefits, and to ensure that they resist the persist tendency toward centralization that exists in all countries.

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