

A Political Efficiency Case for Federalism in Multinational States: Controlling Ethnic Rent-Seeking¹

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A. Introduction: Constitutional Choice, Rationality and Ethnic Clubs

The last two decades have witnessed a remarkable period of constitutional development and reform as a great wave of constitution based democratization has swept through South America, Africa, Europe, and Asia. In nearly all cases, constitution writers confronted national populations that were far from ethnically homogeneous. In the former Soviet Union the new nations included large numbers of Russians immigrants and one or more indigenous peoples. In Africa, the regions to be organized and governed included many tribes with conflicting interests. In South America persons of European, Asian, and native Indian decent were to jointly governed under reformed constitutions. Constitutional reforms to accommodate differing national and ethnic interests continue to be debated in Canada and within the European Union.

Multinational countries confront a number of political and social problems that may not arise in more homogeneous countries. Perhaps the most difficult of these are political as noted by Breton (1964). Political and social problems arise when ethno-nationalist groups use governmental powers to create and/or enforce public policies that advance ethno-nationalist aims. Such policies undermine the rule of law insofar as laws are neither enforced nor drafted with equal protection in mind. Unequal policies often undermine the

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legitimacy of governments in the eyes of the repressed, reducing the extent to which informal norms can be relied upon to buttress the formal rules of the state. Moreover, the mere possibility of such political power encourages ethno-nationalist groups to seek and resist discriminatory political power in a manner which unproductively consumes considerable time, energy and other resources. This paper demonstrates that the institutions of federalism and competitive bureaucracy can diminish these undesirable affects of ethnic nationalism.

The analysis is based on a theory of what might be called "rational" nationalism (Congleton, 1995). Rational choice models assume that individuals participate in all their activities with aim of advancing personal goals in a setting of scarcity. Scarcity implies that all activities have a price. The tradeoffs that must be considered are often complex even in choosing among the mundane tasks of ordinary life. Persons "hire themselves out for wages" when the advantages of salary and other compensation more than suffice for inconvenience, lost leisure, and reduced personal autonomy. Similar tradeoffs exist for persons who consider engaging in ethno-nationalist activities. Using more ethnic food, clothing, and/or expressions limits one's potential range of friends, hobbies, and business relationships. Voting exclusively for candidates from one's own group often reduces the range of potential public policies that may be considered. Providing favors for members of one's ethnic group risks offending other people outside the group in a manner which reduces potential gains from exchange and fellowship. In the end, rational individuals participate in ethnic activities and work for ethno-nationalist organizations when the personal advantages of ethno-nationalist based activities appear to be greater than their costs.

The rational choice approach used in the present analysis is not meant to rule out other possible motivations, such as special altruistic bonds within ethnic groups. Insofar as ethnic nationalist groups are fundamentally based on long term historic relations within and between various families, it is clear that bonds between group members may exist beyond those accounted for by narrow self interest. Such bonds would increase the likelihood that those groups, as such, survive through time. From a rational choice perspective, these same bonds

may be interpreted as increasing the benefits of continued membership in such groups. A more durable group is able to provide a longer term flow of benefits than a transitory group and continued membership in such groups would warrant a greater personal sacrifice.

The claim that underlies the present analysis is that self-interest accounts for a significant portion of the behavior that we observe within and among ethnic interest groups. In Congleton (1995), I demonstrated that a good deal of the ebb and tide of ethnic nationalism can be explained within a rational choice model. Ethnic "clubs" become more important in time periods when other sources of collective services decline and become less important when other sources of collective services flourish. In this paper, I argue that self-interested behavior is sufficient to account for the general pattern of ethno-nationalist politics in a broad range of cases. Discriminatory social and political actions need not be based on supra-individual or monolithic notions of ethno-nationalist groups.

Political problems arise in multinational states because of implications of the existence of distinct "national" groups that may be said to exist in such states. National group distinctions may include such characteristics as geographic origin (Scandinavian), language (francophone), religion (Jewish), culture (European), ethnicity (Chinese), or race (Inuit). Often persons share several of these characteristics which gives them a sense of being related to and belonging to a greater group of similar persons. That is to say, many or most persons in a multinational state have at least one national identity that is distinct from that generated by the civic and cultural life of the particular country in which they live (Breton, 1964, Hardin, 1995, Breton, 1995).

Organizations can be more easily formed by such "natural groups" than by most other collections of unaffiliated persons because a common national identity reduces organizational costs. A common language and culture provides a basis for communication. Common interests and aspirations provide the basis for mutually beneficial group services. Common norms and religion provide a basis for more accurately predicting the behavior of fellow group members in a wide variety of settings where trust or contracts might be issues. Readily

observable manifestations of a national identity--surname, language, accent, and appearance--make it relatively easy to distinguish members from non-members which allows services to be better targeted at fellow "club" members and facilitates the punishment of free riders.

The ethno-nationalist groups that emerge may be rather tenuous organizations that arise spontaneously without any effort by a leadership to coordinate and encourage ethnic based activities. Services in such a minimal "club" may be limited to preferential exchange of information about quality of services, the availability of discounts, and social and employment opportunities--e. g. an ethnic "grape vine." In larger and more formal ethno-nationalist organizations, various forms of social insurance may be provided by the group. "We take care of our own." In still grander enterprises, direct job opportunities, political favors, and, indeed, political power may be provided to members. Formal ethno-nationalist clubs or associations are carefully organized enterprises with a permanent staff of fund raisers, lobbyists, and coordinators.

All clubs provide differential services to members and non-members, but in most private clubs the distinction between members and non-members is more or less voluntary. Persons choose to join or not join most ordinary bridge clubs, health clubs, churches, and civic service organizations (Wintrobe, 1995). However, it is not generally possible to change one's memberships in ethno-nationalist "clubs" because membership is based largely on family history and its associated implications for race, language, religion and heredity. Rewards and costs may lead one to be a *more or less active* member of an ethnic group, but not to change clubs.²

² In "melting pot" countries like the United States, Canada, or Australia, persons may belong to several ethno-nationalist groups simultaneously as products of intragroup marriages. In this case, it may well be possible to effectively change groups insofar as persons may emphasize only a small subset of their potential national identities. On the other hand, even in such cases, membership choices tend to be very limited. That is to say, either just a handful of options exist or none. Options do not really proliferate in a "melting pot" state because the "melting" process attenuates links to specific ethno-nationalist groups. In the long run, a multinational state becomes effectively a homogenous state of people with *clear* links only to their current place in the world: e. g. they become Canadians, Australians or Americans.

Since only persons who belong to "a people" are eligible for services provided by ethno-nationalist clubs, differential treatment of persons based on what loosely may be regarded as ethnicity is a natural consequence of such clubs. Moreover, because group membership is based on unchanging family membership and history, there will be essentially *permanent distinctions* between club and non-club members that imply significant discrimination among groups in the production and distribution of all ethno-nationalist club services.

What potentially makes nationalist or ethnic based clubs of greater interest to political scientists and economists than other hereditary clubs, like the extended family or clan, is that an ethnic group's relatively large size potentially gives it the ability to significantly influence the distribution of wealth between members and non-members. Such wealth effects may be a consequence of favoritism in private activities alone, or more likely, they may be a consequence of the direct use of the coercive power of the state to further ethnic-nationalist group ends, Breton (1964), Roback (1989). The stability of national identity also implies that political power may be wielded by a single group over a significant time period with the consequence that discriminatory policies may remain in place for many generations. The hereditary basis of membership increases coalitional stability and makes electoral cycles less unlikely.

B. Two Illustrations of Favoritism under a Unified Government: Accidental Natural Monopoly and Conscious Rent Seeking

The observation that the powers of government may be used to provide ethnic services does not necessarily imply that an organized self-conscious effort to influence policy will be forthcoming from all ethnic groups, nor are such efforts necessarily required. The first case examined below demonstrates that the private rewards available to members are often sufficient for favoritism to emerge even when ethnic clubs do not aspire to political power *per se*. The second case examined demonstrates that active political efforts by ethnic-nationalist clubs may generate significant political costs whether legislated favoritism is obtained or not.

The analysis is based on the reciprocity that plays a role in every club. To maintain good standing within a club, every member of the club must "pay" his dues. These dues may be relatively modest for inactive members who receive relatively few services from the club. Indeed, insofar as ethnic club services are imperfectly excludable or targeted at club members, inactive members of an ethnic group may free ride to some extent on the political and economic activities of fellow group members. However, as noted by Olson, 1965, in his analysis of general features of collective action, most successful ethnic clubs will have at their disposal some selective incentives that can be used to provide larger rewards for those who provide greater contributions to club activities.³

In informal ethnic clubs, both club dues and club services consist of favors. An exchange of services takes place, but generally not illegal bribes in cash or kind. The terms of trade remain implicit rather than explicit. In such organizations, outstanding producers of ethnic services may be provided with more complete information about business, social or political opportunities, may receive more or greater discounted services from other members, and/or may be singled out for significant approbation and respect from fellow club members. In formally organized groups, outstanding coordinators, managers and producers may be directly rewarded with salary and bonuses, and with promotions to positions of greater authority and honor.

i. Natural Monopoly: An Model of Accidental Favoritism

Any member of an organized group that is employed by government is in a position to use the powers of his government office to secure such club rewards. Consider the position of an isolated low level government clerk, Al, perhaps an immigration official, building inspector, or tax collector. Al earns a salary from his job, Y, and has some prospect for advancement which will increase the present value of his salary by B. Suppose further that

³ Although, as noted above, there are a broad range of criteria upon which nationalist groups may be based, this paper will hereafter refer to all groups composed on the basis of nationalist aspirations, culture, or heritage as ethnic groups. The term "ethnic" club for expository convenience as a short form of the more cumbersome, and more accurate, ethno-nationalist club.

Al works in an ethnically neutral state, and is more likely to be promoted if he is unfailingly neutral in the discharge of his duties. In an ethnically neutral state, the probability of promotion, P , to a better paying position falls when Al provides ethnic services (favoritism, F) to members of an ethnic group, $P = p(F)$, with $P_F < 0$.

In compensation for any risk that Al runs for providing favors to fellow group members, Al receives indirect income from his ethnic club in the form of lower prices, better information, or approbation. The more favors that he provides to his ethnic group, the greater are these sources of ethnic club based income, $E(F)$ with $E_F > 0$. Al's total expected income is the sum of ordinary salary, expected promotion, and ethnic-club based income:

$$Y^e = Y + PB + E$$

The income maximizing ethnic clerk provides favoritism at the level that optimally trades off diminished prospects for promotion with the rewards of providing services to his group. Differentiating with respect to F and setting the result equal to zero allows the income maximizing level of favoritism for Al to be characterized as:

$$P_F B + E_F = 0 \tag{1}$$

Al will produce favors for his own group up to the point where the expected marginal loss from reduced prospects for future promotion equals the marginal increase in ethnic income produced from those favors.⁴ It is clear that as favoritism becomes less costly *at the margin* (P_F becomes less negative) and as the marginal rewards from the Ethnic group increase, (E_F increases) favoritism will tend to increase, other things being equal.

In a competitive labor market where all ethnic groups are equally well organized and effective at rewarding favoritism, there will be many such clerks, from many different ethnic groups, and the overall effect is that on average the tax code, building code or immigration

⁴ Of course, rather than a bonus for good performance, the clerk might be subjected to penalties for poor performance. This difference is unimportant for the purposes of this paper.

rules are implemented in a manner that is somewhat more permissive than originally intended by those drafting the relevant rules and regulations. Each group gets treated more favorably by its "own" clerks which in turn leads to an ethnic-based sorting of clients among clerks. But, there is not any systematic bias in the resulting pattern of regulation and enforcement.

However, in cases where a few ethnic groups are better able to reward (or punish) their members than others, members of those better organized groups will be most interested in positions where discretion allows valued favors to be produced at a relatively low cost. Moreover, since members of those more rewarding groups receive a higher total income from such positions, more talented members from such groups would be willing to accept employment at a given government wage level than would be willing to accept employment from less remunerative groups, other things being equal.

To the extent that the government's personnel office has an incentive to minimize the cost of qualified personnel, or to hire the most highly qualified person for each position at a given salary, members of the ethnic group that most rewards government service most will tend to secure *all* such jobs. This kind of separating equilibrium in the market for clerks tends to occur even in cases where those making the hiring decisions are entirely neutral in evaluating the relative merits of prospective clerks. Discriminatory hiring is not necessary for this result to hold. Self selection is sufficient.

One troubling consequence of such an ethnic natural monopoly is that only a single ethnic group benefits from the favoritism generated by the discretionary authority of government employees. Only the "insider" group benefits from the clerk's ability to confer favors, because it is only through serving fellow group members that clerks earn additional ethnic club based income. Persons outside that group are all treated equally, and persons within the group are all treated equally. However, even uniform regulations would be applied unequally across groups.

Favoritism at the level of individual clerks remains limited by the same personal tradeoffs as in the previous case--ethnic services versus reduced prospects for promotion--as

long as the ethnic natural monopoly occurs only at lower levels of the bureaucracy. However, as the dominant ethnic group is gradually promoted into the organizational hierarchy, favoritism may be introduced to the hiring process, and for the drafting of rules and regulations developed to implement legislation. Indeed, even non-ethnic clerks who report to members of a dominant ethnic group would be well-advised to continue providing favors to relevant ethnic group members.

In any case, it is clear that the existence of a dominant organized ethnic group can undermine the rule of law in areas under their member's authority. Clearly equal protection of the law will not apply in an ethnically captured bureaucracy because the immigration regulations or tax code, etc. are applied in a differential manner across groups. As the drafted regulations themselves become discriminatory, equal protection of the law disappears even as a policy goal.

It is also clear that transfers from the population as a whole to the preferred group may be significant even in cases where the method of securing transfers is limited to a biased exercise of unavoidable bureaucratic discretion. For example, suppose that the bureaucratic service that is monopolized is on-site building inspections. Building inspectors have considerable discretion to decide whether a particular building practice does or does not meet the local building code. If it were known that builders from a particular ethnic group routinely received speedy approval for their work, demand for the services of such builders would clearly increase. Unless favoritism were extreme, it would be of little concern to consumers whether speedy approval of work done by favored groups was a consequence of favoritism or high quality workmanship. Nor would the standards applied to other builders have to be excessively high or arbitrary for favoritism to affect personal incomes. Time is money in the building trades. Income would increase for contractors from favored ethnic groups insofar as the supply of such builders is not perfectly elastic, and decline for other builders.

The wealth effects of ethnic based favoritism are affected by a variety of demographic and cultural aspects of particular ethnic communities. For example, there may be taste or occupational differences that lead some ethnic groups to reward favoritism (and thereby government jobs) in some policy areas more than in others. One ethnic group might come to dominate building inspections, another immigration and still another taxation. Specialization in particular government agencies or activities may be unintentionally reinforced by other informal rewards provided by ethnic groups that encourage investment in various forms of human capital--such as language, military service, or higher education--which causes particular groups to have a comparative advantage at specific positions within the bureaucracy. Such factors may reinforce or limit net transfers from the community at large to members of a particular ethnic group.

The prospect of bureaucratic capture by an ethnic group may be reduced in a variety of ways. For example, legislation that requires a proportional ethnic quota system in hiring clerks, would, in a manner analogous to antitrust activities, artificially move the distribution of bureaucratic personnel back toward the diffuse competitive setting first explored. The quality of personnel may be diminished by such quotas, but favoritism in the implementation of policy would also be diminished.⁵ Alternatively, institutional structures may encourage competition between bureaus which reduces the possibilities for ethnic capture of particular government service areas without necessarily reducing the talent of the government work force. Bureaucratic transfers may also be limited by imposing stronger sanctions on those found engaging in favoritism.

However, the ethnic based sorting characterized above does not have to be complete to be of interest, or to have significant consequences for the citizens of the country of interest. As long as some groups are able to secure preferential treatment, *on average*, both the effective legal system under which individuals operate and the consequent distribution of personal

⁵ Such legislated solutions are less likely when the benefiting group constitutes the political majority, and are effectively ruled out under authoritarian regimes in cases where those groups benefiting are important supporters of the current regime. Within such authoritarian regimes, the end of preferential treatment may require a political revolution.

income will be affected by membership in ethnic groups that more or less successfully exploit the discretion associated with government office.

ii. Political Competition and Ethnic Rent-Seeking Losses

The latter points to another potential source of ethnic favoritism. Rather than simply rewarding those individual members who secure useful political power, ethnic clubs may organize for direct participation in state politics. Within a democracy a politically active ethnic group may attempt to influence legislation by directly lobbying policy makers for specific policies or by selecting particular parties or politicians to support with group resources. Within an authoritarian regime, a politically active ethnic group may promote or resist the rule of a particular dictator or ruling council. In either case, some policy is adopted or a particular candidate is elected, and favoritism becomes a matter of legislation rather than an accidental consequence of ethnic comparative advantage under neutral hiring practices.

In cases where two or more groups take opposing stands or back opposing candidates or policies, the resulting political contest has the general features of a rent-seeking game. Resources are invested in a contest which is itself largely nonproductive in the sense that decisions at the political margin redistribute existing wealth rather than create new wealth.⁶ Resources invested in political conflict largely offset each other. Thus, in many cases a similar policy result could have been obtained at a lower cost if each group had proportionately reduced their investment in the political contest. The resources unnecessarily invested in ethnic conflict constitute a political and economic deadweight loss. In the case of open warfare between ethnic groups for political power the dead weight loss of political conflict is often obvious and huge as lives, labor and capital are consumed by violent conflict. Peaceful forms of political conflict are often difficult to directly observe, but may also consume considerable resources.

⁶ The rent-seeking game has been applied to analyze interest groups activities in a wide variety of settings. For an overview of the literature and several applications, see Tollison and Congleton, 1995.

The potential magnitude of the dead weight loss of both sorts of political conflict can be analyzed with a model of rent-seeking drawn from elementary game theory. Suppose that ethnic group "A's" probability of securing a transfer, T, via the contest of interest is approximately equal to the ratio of their efforts, E^A , to all others, E^O , $P^A = E^A / (E^A + E^O)$. Suppose further that the cost of each unit of political effort is simply C. In this case, A's expected net benefit, N^e , from engaging in political activity is simply the expected transfer less the cost of the effort undertaken.

$$N^e = P^A T - E^A C \quad (2)$$

Differentiating with respect to E^A and setting the result equal to zero, allows ethnic group A's political profit maximizing investment in rent-seeking to be characterized as:

$$[- E^O / (E^A + E^O)^2] T - C = 0$$

or

$$E^A = - E^O + [TE^O/C]^{1/2} \quad (3)$$

Clearly the amount that any single ethnic interest group wishes to invest in the political contest depends upon the extent to which those investments increase the probability that it will be successful, which in turn depends on the efforts of all other ethnic groups. Equation 3 characterizes this relationship for a typical interest group. All the ethnic groups that seek this prize face a similar decision problem and would reach similar conclusions.

A political equilibrium occurs when no group has a reason to change its behavior given the choices of all other groups. This occurs at the Nash equilibrium of the political influence game where all the groups are simultaneously on their best reply functions (similar to those characterized by equation 3). Consider the very tractable equilibrium that emerges if there are K-1 other equally well organized and effective groups participating in the political influence game of interest. At the symmetric equilibrium all groups make the same

investment in rent-seeking activities, so $E^o = (K-1) E^A$. Substituting into equation 3 and solving for E , allows the Nash equilibrium political effort of each group to be determined:

$$E = (1-1/K) T / KC \quad (4.1)$$

and total rent-seeking cost, R , across all K groups is:

$$R = KEC = (1-1/K) T \quad (4.2)$$

Note that both single group investments (4.1) and the total amount invested among all groups (4.2) increase as the political prize (T) increases. In the illustrating example, the investments are proportional to the prize sought. In a two ethnic group contest, each group invests an amount equal to one fourth of the prize sought, here $EC = (1-1/2)T/2 = 1/4T$.

Perhaps of greater interest for the purposes of this paper is the relationship between the total expenditure, R , and the number of ethnic groups involved in the political allocation contest. Note that as K gets large, the total amount invested approaches T , the total value of the transfer sought. That is to say, a multinational state in which ethnic or nationalist groups seek transfers or favorable regulations from government tends to waste more and more scarce economic resources in political conflict as the number of politically active ethnic groups increases. In a state with two more or less equally sized politically active ethnic groups, resources equaling about half of the desired transfers are consumed by the process of political conflict. In a state with four such groups, three fourths of the transfer sought are consumed by political conflict.⁷

⁷ These losses might be moderated to some extent if the groups form coalitions and agree to share and political prize obtained. Losses might also be limited in cases where there are fixed organization costs to participating in the political process. Here, a point would be reached where entering the political game becomes unprofitable. That is to say, fixed costs may limit the number of groups that would find it worthwhile to compete in such games.

It also bears noting that fixed costs may limit aggregate rent-seeking activities as K get large. As a nation's population is divided into smaller and smaller segments, eventually group resources may be insufficient to "pay" the fixed cost of entering the rent-seeking contest. Ethnic politics are more important at the local level than at the national level within the US, apparently for this reason.

Of course, these specific results follow from the model of ethnic conflict explored and are not meant to be quantitative predictions. The model is meant to illustrate the fundamental structure of conflict between ethno-nationalist groups rather than provide a totally faithful representation of actual conflict that we might observe.

Clearly, the model, as such, has several weaknesses. (1) The probability function used can only roughly approximate the complex web of personalities and ties within a nation's political process that give rise to influence. (2) There may be significant asymmetries among the various group abilities to devote resources to the political contest. (3) Moreover, as the number of groups increase within a given national population, group membership and resources may fall. Only the diminished probability of winning is accounted for in the multinational group setting by the model. To the extent that additional numbers of politically active groups is caused by some reawakening of national identity induced by changing circumstances, it is possible that the decline in investment by members of now smaller ethnic groups would be more rapid than modeled above and that the analysis of total resources devoted to political conflict would not be directly relevant.

On the other hand, although particular features of every abstract model are necessarily unrealistic, the use of models remains a useful device for analyzing the world because many "unrealistic" features of models are "sufficiently" close to reality in a large number of interesting cases. Many specific objections to using this particular model as an engine of analysis are less relevant than one might initially believe. For example, the concerns just noted may be at least partly addressed as follows. (1) Many other probabilistic representations of the process of political influence would yield *qualitatively* similar results. (2) In the absence of long-standing discrimination, there is no particular reason to expect one group to be better organized or more politically effective than another. (3) There is no necessary decline in group membership as the number of groups included in the multinational state increases. Multinational states tend to be agglomerations of many peoples with separate national identities. To the extent that nationalist politics is based on long standing differences

in identity, changes in the number of groups does not take place within a given society but only across different countries or via merger and conquest.

Given these acknowledged limitation of the model developed, the game theoretic representation of decisions to invest resources in political conflict indicates that multinational unified states will tend to consume considerable resources in political conflict among ethnic interest groups to the extent that institutional arrangements makes such effort potentially profitable. Not only are the political prizes in multinational states relatively large, but the more numerous the politically active ethnic groups are the greater the resulting rent-seeking employment of resources tends to be.

C. Federalism as an Institutional Solution: Advantages of Local Political Competition and Monopoly

The magnitude of the losses associated with political conflict and the extent to which policies are systematically biased to favor specific ethnic groups are affected by legal and political institutions in at least two ways. Institutions may explicitly restrict opportunities for discrimination by limiting the scope for government action and the extent to which the government may discriminate among persons or groups within the domain that it has retains jurisdiction. For example, rules requiring just compensation and due process limit the ability of governments to make direct transfers between individuals and groups. Secure general property rights and civil rights explicitly bound the domain of government policy in a manner which rules out some methods of government favoritism. Rules that assure equal protection of the law similarly make discriminatory legal practices more difficult to draft and implement.

Alternatively, laws may indirectly control the extent to which governments may discriminate by specifying procedures or organizational features that make discriminatory outcomes unlikely. For example, majority rule elections limit large scale transfers from mainstream groups to levels which can be readily tolerated by a majority. Reliance on a redundant, but competitive, bureaucracy also reduces the risk of ethnic capture as noted above.

Another organizational feature of government that can limit the scope of ethnic favoritism and ethnic conflict of paraticular interest here is federalism. Federalism is a somewhat ambiguous "form" of government inasmuch as nearly all governments are "federal" to some degree, although, the degree of decentralization varies significantly across countries. The polar "nonfederal" case is that where all political authority resides in a single country wide government, a unitary state. Local authority in such unitary governments is a consequence of revocable decisions by the central authority to delegate authority to local agents who are themselves appointed by the central government. Unitary government was implicitly the form of government analyzed above.

At the other end of the spectrum of "federal" governments are highly decentralized organizations in which the national government has very limited authority. Autonomous and independently elected local governments determine and provide most government services financed from local tax resources. The national government of a decentralized federal system guarantees the *free mobility* of peoples and products among the governments, and help *coordinate* the provision of nationwide public goods and the regulation of national externalities. In a broad range of intermediate cases, fiscal responsibilities may overlap or be shared by several levels of government, and significant services may be provided by the central government. In cases where considerable autonomy to make public policy remains in the hands of local governments, local government policy decisions depend in part on policy decisions made by other local governments.

The previous analysis of ethnic favoritism applies in a general way to the situation faced by each government within a federal system. Opportunities for ethnic favoritism exist at every level of governmental autonomy, and accidental and intentional ethnic preferences may emerge within all those areas of policy making, implementation, and enforcement. However, the analysis of this section of the paper indicates that the degree of preferential treatment that specific ethno-national groups may *realize* is significantly more limited within federal governments than within unitary governments.

The relevance of federal systems of governance for addressing the political problems of multinational states has largely been neglected, although some hints of solutions are present in Warneryd, 1997, and Congleton, 1994, and Hoyt and Toma, 1989. Most of the work that assesses relative advantages of competition within federal systems and within the bureaucracy has implicitly been done within fairly homogeneous communities. In such a setting, it has often been argued (Tiebout, 1956, Henderson, 1985, Breton (1987), and Wintrobe, 1987) that competition can improve the performance of government by constraining its ability to raise taxes without providing desired services, and encouraging innovation. In extreme cases, local governments behave as if they were simply competitive firms and local government services are provided to residents at marginal cost. Similarly, bureaucracies that provide services to the central government which are available from other government (or private) suppliers are constrained to provide high quality services at least cost. In these cases, the costly redundancies of local governments and of parallel and overlapping agencies are more than offset by the productive competition engendered by multiple service providers.

Other conclusions about the relative merits of federalism in a multinational state differ from those of analyses conducted in homogeneous states. For example, Oates, 1972, notes that fiscal federalism can be defended on the basis that uniform services provided by a central government do not properly account for variation in tastes among regions. The standard economic analyses of competition within federal governments tends to emphasize equilibria where local governments serve different local needs at least cost. By contrast, in a multinational state, the political problem may be opposite that which the fiscal federalism literature focuses on. The central government of a multinational state might provide service variation even in cases where uniform services would have been appropriate. That is to say, the central government of a multinational state may distribute services in a manner that discriminates *too well* among ethnic national groups. A well-functioning federalism in this case would produce *more uniform* service levels than a central state dominated by a subset of national groups would have.

To the extent that ethnic favoritism subjects non-favored groups to higher taxes, more stringent regulation, or fewer government services, mobility will tend to reduce the impact of favoritism on *both* the favored and unfavored segments of society. Any local government that engages in relatively greater favoritism will tend to lose unfavored residents (and tax base) to other communities which provide services on a more neutral manner. At the same time that exit of the unfavored occurs, communities that favor one group over another will attract "favored" residents from other communities where they receive fewer advantages. These two effects imply that favoritism in the face of mobility tends to cause jurisdictional sorting by ethnic groups and relatively less actual favoritism than would exist in a society with more limited mobility.

i. Competition between Local Governments

Consider first the extreme perfectly competitive case in which the cost of moving, M , between local governmental jurisdictions is zero. That is to say, suppose people can costlessly relocate from one political jurisdiction to another, $M = 0$. In order for moving costs to be so low, there must be a large number of perfect substitute communities for each person in the country as a whole. (In the absence of a large number of substitute communities, sacrifices and tradeoffs would necessarily be involved in every move, which would imply positive moving costs.) Under perfect jurisdictional competition, every person can choose to locate in a community that produces his desired services at least cost. In this case, it is clear that prospects for ethnic favoritism and exploitation are necessarily very limited.

In the case where every person can choose among several (efficiently sized) communities providing similar services, the existence of ethnic favoritism in any single community implies that that community will, in equilibrium, be perfectly homogeneous in its ethnic composition. Anyone who finds himself to be a member of an unfavored group would simply relocate to another community where his own ethnic group is favored or at least not relatively disadvantaged. Members of favored groups that are not equally favored in their current locations would migrate to the locality where they might best profit from local

discrimination. Thus, Tiebout-type competitive equilibrium in a federal multinational state with local favoritism is characterized by many essentially *ethnically pure* local governments producing various local government services at least cost.⁸

Obviously, favoritism can have only very limited effects on the distribution of wealth within such an equilibrium. Favoritism is a relative notion. One can not truly grant preferential treatment to everyone in a community. After sorting takes place, every resident receives the same treatment because in the end, the residents of each community are all the same in their ethnicity and demands for public services. For example, complete sorting implies that *all* bureaucratic services are monopolized by a dominant ethnic group. However, complete sorting also implies that *all* those seeking services will be members of the same ethnic group. Thus, a building inspector that provided preferential services to every member of his own group would treat every builder under his authority in exactly the same way. Favoritism causes sorting, but in the end, sorting eliminates the effects and effectiveness of favoritism.

What favoritism remains, discourages further emigration (or invasion) of other ethnic groups. This remaining element of favoritism eliminates the "ethnic mixing" which immigrant-based societies claim to benefit from, and may, thereby, somewhat impoverish the cultures of each community and the country as a whole. None-the-less, equal protection of the law exists within every community, and incentives for ethnic based rent-seeking are eliminated. Perfectly competitive federalism, thus, avoids the principal political and legal disadvantages of politically active ethnic nationalist groups.

ii. Ethnic Favoritism within Local Governments with Monopoly Power

⁸ Note that to the extent that multicultural communities are indeed financially or culturally wealthier, and therefore more desirable, communities, federalism also allows institutions that encourage the equal treatment of all citizens to be independently adopted and disseminated. In long run equilibria, one might find a mixture of homogeneous communities of individuals who receive substantial (non-governmental) services from ethnic clubs and other heterogeneous communities where the principle sources of personal income and services are based on nonethnic affiliations.

That a perfectly competitive federal system can eliminate the two principal political costs of intrastate nationalistic conflict is at least of passing interest in large states where numerous opportunities for locational choice exist. On the other hand, moving costs are rarely so low that persons will relocate from one community to another for minor reasons. In this respect, the advantages of federalism are exaggerated within perfectly competitive models of jurisdictional choice because of the extreme assumptions made about individual mobility and range of local governments that services may be chosen among. Anyone who has moved, knows that moving costs can be significant even when the distances involved are small. Moreover, the number of communities that can be chosen among is clearly more limited than assumed in perfectly competitive models. Thus the complete sorting and efficient provision of government services implied by the perfectly competitive model are unlikely to fully obtain.

On the other hand, federalism has political advantages over unitary government in a multinational state even without extreme Tiebout-type assumptions. These political advantages arise largely because the cost of moving between local governments within a country is necessarily smaller than that of moving between countries. Far more moves take place between neighborhoods within a city, than between cities, and between countries.

Consider, for purposes of illustration, the level of resources that will be invested in political conflict within a country with L equal sized autonomous local governments. Suppose that there are N^L residents in each district and that moving between districts costs M^L while moving between countries costs M^C , with $M^C > M^L$. By moving costs, it is again meant the total sacrifice involved in changing locations. These costs include such things as greater distance from friends and family, reductions in income, loss of location specific information and amenities, as well as the physical cost of relocating one's possessions to the next best community. The relative size of these tangible and intangible moving costs allow us to bound the maximal transfers that can be financed locally and nationally.

The greatest transfer that can be financed from a single local or national citizen is his opportunity cost of moving: M^L for local governments and M^C for national governments. The mechanism of the transfer is fundamentally unimportant to persons adversely affected. Regardless of whether losses from government services are an innocent consequence of accidental monopolization of relevant government services, or the result of intentionally discriminatory legislation generated by organized rent-seeking efforts and adopted by local legislatures, residents that expect to lose more than their moving costs can leave the community and avoid being the source of such transfers. Consequently, the maximal transfer that can be undertaken by a local government is $M^L N^L$.

Suppose that K local ethnic-nationalist interest groups participate in a maximal local rent-seeking for this transfer which has the same format as the national game previously analyzed. From equation 4.2 above, we know that local ethnic political conflict will consume :

$$R^L = (1-1/K) M^L N^L \tag{5}$$

resources at the Nash equilibrium. In the perfectly competitive federal environment, each community is homogeneous so $K = 1$, and no ethnic rent-seeking takes place. In the case of interest here, the number of ethnic rivals in a local jurisdiction, K^L , is greater than 1, but tends to be smaller than the number of groups in the country, K^C , as a whole to the extent that any sorting of groups has taken place under federalism. Given, $K^L < K^C$, it is clear that fewer resource will be invested in political conflict locally than nationally whenever the same political prize is at issue.

On the other hand, national transfers can be much greater than that of any single local jurisdiction because national population is greater than local population and, perhaps most significantly, moving costs are greater. Maximal national transfers can be represented as $L N^L M^C$. Resources devoted to political conflict to receive such a maximal national transfer would be:

$$R^C = (1-1/K^C) LN^L M^C \quad (6)$$

This is clearly much greater than the resources devoted to political conflict in any single local jurisdiction, and, of greater relevance for the present analysis, exceeds that of all L jurisdictions combined. The latter can be written as:

$$LR^L = (1-1/K^L) LN^L M^L \quad (7)$$

Comparing equations 6 and 7, it is clearly the case that ethnic based political conflict is smaller in a decentralized federal system for two reasons. First, greater mobility implies a smaller local political prize to be competed for, $M^C > M^L$. Second, greater ethnic homogeneity implies that fewer competitors in the political game, $K^C \geq K^L$. Together these imply that maximal rent seeking costs fall unambiguously as programs are moved from the central government to local governments.

Of course, both local and national jurisdictions can reduce the extent of conflict that actually occurs to levels below these maximal levels by adopting rules and procedures that make potential transfers smaller and more difficult to achieve. (It is not always sufficient to increase the cost of ethnic conflict itself, since changes in cost may not affect expenditure levels. In the examples above, cost was an initial parameter of the game, C , but did not influence total expenditure levels.) Rules that reduce ethnic based transfers, such as adherence to a generality principle, equal protection of the law, uniform service constraints, strongly punishing those engaging in favoritism, and the use of competitive bureaucracy all can reduce expected payoffs from rent-seeking and thereby the extent to which a person or ethnic group would be willing to pursue political influence.

To the extent that both the national and local governments adopt institutions that reduce potential transfers, analysis of the relative costs of ethnic conflict in federal and unitary states would have to be modified to take account of the new maximal transfer levels. The

methods used by both national and federal governments would naturally tend to be similar, and potential transfers would be, more or less, proportionately reduced by measures taken at both levels of government. In this case, the relative size of the losses from ethnic conflict would be approximately the same as in our examination of the maximal case.

Federalism and parallel bureaucracy in a multinational state, may actually *reduce overall political competition*, but increase welfare insofar as many of the forms of political competition in a unified multinational state tend to be unproductive ones.⁹

D. Ambiguous Federalism?

The case for federalism as a method of reducing political costs in a multinational state is weakened somewhat in settings where services overlap or are shared among many levels of government. In this case, federalism creates another arena of political conflict over the appropriate level of government at which specific authority for particular policy decisions should reside that does not exist in a unitary state. Insofar as policy making authority remains at least partly decentralized in such governments, the political advantage of federalism developed above still apply in areas of local control. However, the extent to which ongoing dispute over the division of power between local and federal governments tends to affect the relative merits of federal and unitary systems of governance is matter of concern for the case of what might be called "ambiguous" federalism.

An ethnic group that expects to dominate a unified government would clearly benefit from efforts to shift control from local governments to the central government. Those who expect to be relatively disfavored in a unified state would lobby against greater centralization of authority and for greater decentralized control.

⁹ One would expect competition between local governments within a multinational state to encourage local innovation in institutions that reduce political conflict to the extent that there are obvious advantages to multicultural communities and insofar as institutional innovation is politically less difficult at local levels of government than at federal levels. Thus, it is likely that reductions in ethnic based rent-seeking will, on average, be proportionately greater within local governments than within the central government.

Some insight about the magnitude of the resources that would be invested in resulting political conflict over the appropriate level of decentralization can be obtained through a modest extension of the previous results. Recall that additional transfers can potentially be made by the central government because international moving costs exceed intranational moving costs which allows central governments to engage in greater exploitation of groups out of power. In a country where relatively little sorting of ethnic groups takes place among local jurisdictions, so that each local jurisdiction resembles the nation as a whole, the increased "political prize" is proportional to the difference in international and intranational moving costs.

From equation 6 and 7 above, this additional potential transfer, T^C , avoided in a federal state can be written as $T^C = LN^L (M^C - M^L)$. The resources used to seek and resist such a transfer would be:

$$R^F = (1-1/K^C)T^C = (1-1/K^C) LN^L (M^C - M^L) \quad (8)$$

Equation 8 indicates that the net savings of federalism are partly dissipated in conflict over the "proper" locus of power in the model developed here. Thus, ambiguous federal systems have smaller political advantages over unitary government than federalisms with more rigid dispositions of authority between central and local governments. Nonetheless, ambiguous federalism still has a political advantages over a unitary state insofar as total political conflict remains smaller than it would have been within a unitary state.

The previous analysis also indicated that the extent of the conflict over the level of authority varies with the number of groups involved. Equation 8 indicates this as well. However, it bears noting that decisions to locate policy authority at one or the other level of government generally do not favor *specific* groups, as was the case examined in the previous analysis, but rather *all* groups that prefer a federal or centralized disposition of authority. Consequently, conflict over the proper extent of decentralization causes two natural coalitions

of ethnic groups to form--those favoring and opposing increased centralization--which reduces deadweight losses from political conflict. (Recall that as the number of parties to the conflict diminishes rent-seeking losses diminish from $(1-1/K^C) LN^L (M^C - M^L)$ to $(1-1/2) LN^L (M^C - M^L)$.) Although half or more of the expected increase in the central government's power to make transfers may be consumed in political conflict within an ambiguous Federalist state, conflict as a whole diminishes within an ambiguous federal state relative to a centralized state.

E. Conclusion: Federalism's Appeal in a Multinational State

In any state not rigorously bound by what Buchanan and Congleton (1998) have referred to as a *generality principle*, governments are free to create policies which differentially benefit persons and groups. In such a setting, ethno-nationalist groups, like other interest groups, may regard the government as simply another possible means of producing "club services." Group members may desire new or increased regulations favoring particular industries in which they are owners or employees. They may also desire and secure relatively narrow services and targeted income transfers financed by tax payers at large.

This paper has shown that federalism can reduce two important political and legal problems associated with the political activities of ethno-nationalist groups. The argument can be summarized as follows: Political favoritism encourages persons to migrate between communities insofar as the costs and benefits of government services vary among communities for specific peoples. The cost of migration is smaller for movements between local governments than for movements between national governments that between national governments national governments. Consequently, communities will be more ethnically homogeneous than nation states, whenever ethnic groups are directly or indirectly politically active. Increasingly homogeneous communities reduce the scope for potential favoritism and imply that a smaller number of ethnic groups will compete for preferential treatment. Fewer *effective* discriminatory laws will be forthcoming in federal government than under unitary

governments which reduces the interest and thereby the waste generated by ethno-nationalist rent seeking. Together these imply that investments in political conflict, rent-seeking losses, will be smaller in federal systems than in a unitary state. (In the limiting case with complete sorting of groups among local jurisdictions, ethnic conflict and most effects of favoritism disappear within the homogenous jurisdictions that emerge.)

An implication of the analysis is that transferring program responsibilities to local governments reduces potential political conflict by reducing moving costs and increasing the degree of governmental competition. Consequently, more decentralized systems of federalism have smaller political overhead costs than more concentrated ones because conflict over central government policies is replaced by somewhat smaller aggregate conflict over the policies of local governments.

On the other hand, the political efficiency advantage of decentralization of policy making authority does not imply that central governments should be eliminated. Dividing a multinational state into separate independent countries fails to secure the benefits of decentralization within a federal state because moving costs, no matter how small, are nearly always greater, and therefore jurisdictional competition less, between countries than between jurisdictions within a single country. Conflict within a large number of independent countries would exceed that within even a fairly centralized federal system if the independent countries or ethnically heterogeneous. Both small and large unitary governments have incentives to make moving costs large in order to increase their power to make transfers. Moreover, advantages of scale in economic markets, in national defense, and in internalizing regional externalities suggests that a central government may be an important mechanism for producing genuine national public services.¹⁰

¹⁰ Many of the advantages of federalism can be secured via self-enforcing international treaties. Treaties that guarantee the free movement of persons and property, together with ones that provide for regional defense and regulation of externalities provide are the only method by which advantages of competitive governance may be secured by economically interdependent, but politically interdependent, unitary states. Such multilateral treaties create, in effect, a type of confederation where the power of participation, and at least a local veto, remains in the hands of "local" governments. Unfortunately, self-enforcing treaties become increasingly problematic to

Around the world, we do observe a rough correlation between the degree of decentralization, discriminatory policies and political conflict in multinational states. The highly centralized multinational governments of Africa often are dominated by a subset of ethnic groups that secure a variety of transfers from the groups excluded from government using the coercive regulatory and taxation powers of the state. Political conflict, and indeed internecine warfare, are often intense within these countries. Contrariwise, conflict within the multinational federal states in North America and Europe is very modest by comparison. Although other institutions and traditions also contribute to diminished conflict in these wealthier nations, the predicted consequences of federalism for national welfare seem to be observable, substantial and obvious.

Overall, the analysis has illuminated some neglected advantages of federalism over unitary governments in the context of multinational states. Federalism does not end ethnic conflict, but it does diminishes the political costs of political conflict and favoritism relative to unitary states. The analysis has developed several reason why fewer *effective* discriminatory laws tend to be forthcoming in federal systems, and why less ethnic political conflict tends to occur in federal systems of governance. Reduced political conflict allows scarce human resources to be shifted from divisive ethno-nationalist conflict to more productive activities. Federalism, thereby, increases the wealth and welfare of most citizens, and thereby the legitimacy of the state itself.

draft as the number of countries involved becomes large. Congleton (1995).

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