

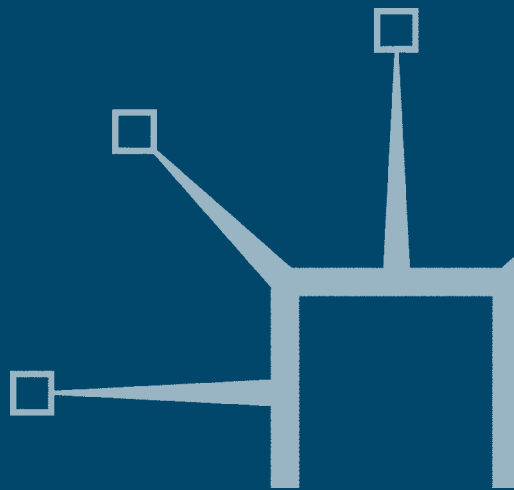
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# The Dynamics of Federalism in National and Supranational Political Systems

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Edited by

Michael A. Pagano and  
Robert Leonardi



# The Dynamics of Federalism in National and Supranational Political Systems

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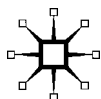
*Professor and Director of the Graduate Program in Public Administration  
University of Illinois at Chicago, USA*

and

**Robert Leonardi**

*Director of the Economic Cohesion Laboratory  
London School of Economics, UK*

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*For Francesco Boccia  
scholar, friend, colleague*

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# Contents

<i>List of Figures</i>	ix
<i>List of Tables</i>	xi
<i>Preface</i>	xii
<i>Notes on the Contributors</i>	xv
1 In the Eye of the Beholder: The Dynamics of Federalism in National and Supranational Political Systems <i>Michael A. Pagano</i>	3
<b>Part I Constitutional and Political Framework</b>	<b>19</b>
Overview and Introduction <i>Celina Souza</i>	21
2 Types of Federalism: Achieving Self-Governing Capabilities in Societies with Federal Potentials <i>Filippo Sabetti</i>	27
3 “Thinking Federally” from a Governance Perspective <i>Susan E. Clarke</i>	55
4 Social Forces, Space and Boundaries <i>Ann O’M. Bowman</i>	86
<b>Part II The Fiscal Framework</b>	<b>101</b>
Overview and Introduction <i>Michael A. Pagano</i>	103
5 Wealth and Tax Systems <i>Jeffrey I. Chapman</i>	107
6 Local Government Own-source Revenues and Debt Financing: Structure and Stress <i>W. Bartley Hildreth</i>	136
7 Fiscal Federalism and Intergovernmental Revenues in the US <i>Christopher W. Hoene</i>	167



<b>Part III The Policy Framework</b>	<b>199</b>
Overview and Introduction	201
<i>Sarah F. Liebschutz</i>	
8 Dividing the Job Revisited: Learning from the United States Case 1789–2006	205
<i>Carol S. Weissert</i>	
9 Efficient and Equitable Service Delivery in a Federal System	223
<i>Daphne A. Kenyon</i>	
10 Intergovernmental Policy Management: Cooperative Practices in Federal Systems	248
<i>Robert Agranoff</i>	
<b>Part IV Conclusion</b>	<b>285</b>
Conclusion	287
11 Thinking About Federal Systems in the 21 <sup>st</sup> Century in Light of the European Experience with “Operational” Federalism	288
<i>Robert Leonardi and Raffaella Y. Nanetti</i>	
<i>Bibliography</i>	305
<i>Index</i>	333

# List of Figures

4.1	The territory of Texas as it entered the union, 1845	87
4.2	Proposals for dividing Texas	88
4.3	Local government territories: 1 county, 5 cities, 2 school districts, 2 towns	91
6.1	State and local government current receipts, NIPA basis, 1959–2004	141
6.2	Local government current receipts and expenditures, year over year change, NIPA basis, 1959–2004	142
6.3	Local government current receipts as percentage of GDP, NIPA basis, 1959–2004	143
6.4	Local government sources of funds as percentage of total, NIPA basis, 1959–2004	144
6.5	Property tax structure index	149
6.6	Sales tax structure index	154
7.1	Total government expenditures, 1902–2001	179
7.2	Federal outlays to state and local governments, 1913–2007	180
7.3	Federal outlays to state and local governments as a % of total federal outlays, 1902–2001	181
7.4	Federal general revenue sharing, 1974–88	182
7.5	Federal outlays to state-local governments: payments for individuals and state-local grants, 1940–2007	182
7.6	State and local government expenditures, 1913–2000	183
7.7	State and local intergovernmental revenues, 1913–2000	184
7.8	Intergovernmental revenues as a % of total and general state-local revenues, 1902–2000	184
7.9	Intergovernmental revenue as a % of state revenue, 1902–2000	186
7.10	Intergovernmental revenue as a % of local revenues, 1902–2000	187
7.11	Local intergovernmental revenue: state and federal shares, 1902–2000	188
7.12	Intergovernmental revenue as a % of total local revenue, 1902–2000	188
7.13	Local and municipal revenues from intergovernmental sources, 1932–97	189
7.14	Intergovernmental revenue as a % of municipal general revenue	190
7.15	Intergovernmental shares of municipal general revenue, 1972–97	191

10.1	Twenty-seven instruments of intergovernmental relations	262
10.2	Intergovernmental management practices	272
10.3	Sixty-three economic development policy/program tools	273
10.4	Sequence of cooperative actions in a tax increment financing project	275
11.1	Theoretical approaches to institution building and policy-making in the EU	296

# List of Tables

1.1 Elazar's typology of federal political systems	3
3.1 Governance strategies and governance tasks: issues	61
3.2 Networks at different scales: advantages and issues	66
5.1 Examples of variation of revenue sources in the United States	115
5.2 Requirements for a successful hard-budget constraint	124
6.1 Relative importance of local taxes in OECD countries, 2003	139
6.2 Property tax in local government finance by type of government unit, 2002	145
6.3 Property tax structure index by state	150
6.4 Sales tax structure index by state	154
7.1 Periods in the development of American federalism	175
9.1 Alternative service delivery options for common municipal services	229
9.2 Municipal use of contracts with private firms for selected services, 1988–97	230
9.3 States "privatizing" programs of services, 1997	232
9.4 Variations in state contracting out after welfare reform	234
9.5 Ownership patterns and trends, by health care domain	242
9.6 Approximate percentage state ownership of business, late 1970s	244
10.1 Allocation of welfare state powers in federal countries	251
10.2 Salem, Indiana's industrial park expansion project	277

# Preface

The rallying cry for political change is more often than not a primordial rage against the *ancien régime* than it is a consensual agreement on the direction of change. From this perspective, almost anything is preferable to the status quo, which solidifies the opposition around a unifying theme of the “anti-” party. Once the “change train” leaves the station, it’s no telling where it will end up – in large part because no one has really clearly articulated the destination even as they have thoroughly analyzed the diseases of the corrupt and dying state. The American comedian, Henny Youngman, had a wonderfully sick sense of humor. One of his jokes went like this: The patient says “Doctor, it hurts when I do this.” “Then don’t do that!” That’s the nature of advice given to polities that do not like what they are feeling at the moment. The lesson: stop doing whatever it is they dislike. The advice not frequently provided would encourage guidance in designing polities, policies, and institutions that would move them away from the corruption of the tired political system. Usually then, the cries for “liberty” and “freedom” and “self-rule” sound as if everyone is in agreement. But once one defines the terms, fissures in the once-solid block of “anti-’s” emerge.

And so it is with “federalism”, the late-20<sup>th</sup> Century antidote to all things corrupt, to the centralized political powers that democratic peoples reach toward, especially for the purpose to end oppression of the center or of the military or of a family or of a tribe. This book is about that antidote, and how it has changed and adapted to circumstances. Federal polities today span the globe and include the older systems in Switzerland, the United States, and Germany to the newer ones in Russia, South Africa and Belgium. Examination of those and other systems would demonstrate a great deal of variation in constitutional design, policies, and intergovernmental fiscal and regulatory relations. What they have in common, however, is that they share a similar, if generally vague, definition of federalism, which according to one scholar is the following: “Federalism provides a technique of constitutional organization that permits action by a shared government for certain common purposes, together with autonomous action by constituent units of government for purposes that relate to maintaining their distinctiveness, with each level directly responsible to its own electorate.”<sup>1</sup> Or in a more elegant and parsimonious manner: “Federalism is essentially a system of voluntary self-rule and shared rule.”<sup>2</sup> Both definitions, together with many others, leave a great deal of leeway in fashioning a federal system that meets the needs of a nation’s citizenry. That is to say, federalism or voluntary self-rule does not by itself provide a

blueprint for erecting a political system or a system of intergovernmental relations and networks. "There is no single ideal federal form."<sup>3</sup>

Citizens and those engaged in the statecraft of designing federal polities, then, are faced with Herculean task of sifting through the histories and theories of federal polities, and adapting the analysis to their peculiar needs, culture, and history. Which form and type of federalism that ought to be adapted to a nation's political system becomes the nub of the political debate. The chapters in this book examine the temporal and dynamic adaptations of federal polities to challenges, political changes, and other socio-political events with a particular focus on the continuously-evolving federal polity of the United States.

The genesis of the book project came about in the summer of 2003 when Prof. Francesco Boccia of Carlo Cattaneo University spent two months in Chicago researching the public finance system of cities in the US. His questions about the relative level of autonomy that cities, or at least some cities, seem to enjoy and the variation in autonomy across the national landscape led him to wonder aloud if his country's decisions to decentralize were made with an understanding of which type of federalism they thought they were moving toward. Indeed, Italy had decided to move toward a federal system as a consequence of a host of events. As one observer noted, "By the late 1990s, the issue on the public agenda was not whether to reform [Italy's] unitary state but, rather, who should decide what kind of federalism to replace it – with regional and municipal governments claiming an equal share in constitutional decision making with national legislators."<sup>4</sup> Boccia's question was more fundamental, not "who" would decide on the nascent federal structure, but exactly what kind of federal system did national legislators and regional and municipal officials have in mind. Indeed, "which" federalism became the question.

The three-day conference was convened at Savalletri near Brindisi in the Puglia region to discuss the "which federalism" question. The purpose of the second day of the conference was to examine how federal polities, with particular focus on the federal polity in the US, evolved, adapted, morphed and changed over time. The papers in this volume, with the exception of the introductory chapter by Michael A. Pagano and the concluding chapter by Robert Leonardi and Raffaella Nanetti, were presented and debated at the conference. Others who served as discussants, engaged in intellectual repartee, and generally kept the level of scholarly debate at a high level during the conference included Kousar Azam, José Manuel Rodríguez Álvarez, Michel Senimon, Adam Steinhouse, Nicola D'Amati, R. Alexander Lorz, Hugo Gonzales Cano, José Ruano de la Fuente, Giuseppe Bettoni, Franco Salvatori, Maria Tinacci Mosello, Enrico Borghi, Angelo Piazza, Gennaro Terracciano, and the president of the Puglia region, Raffaele Fitto. The scientific committee was chaired by Francesco Boccia; others included Giuseppe Bettoni, Robert Leonardi, Raffaella Nanetti, Michael A. Pagano,

José Manuel Ruano de la Fuente, and Gennaro Terracciano. The conference was sponsored by the Scuola superiore dell'economia e delle finanze of the Italian Ministry of Economics and Finance from 12–14 November 2003.

The editors recognize the support and encouragement of Alison Howson of Palgrave Macmillan and in particular the gracious assistance of Gemma d'Arcy Hughes, the Editorial Assistant at Palgrave. They both were instrumental in moving the book through the publication process in an expeditious and efficient manner. The copy editor, Shirley Tan, was most thorough in moving the manuscript through the editing stages, and a delight to work with. The most important debt is owed to Francesco Boccia, who is currently the Economic Advisor for the Prime Minister's office and to whom the book is dedicated, for his conceiving, planning and executing the "Which Federalism?" conference at a most delightful site on the shores of the Adriatic Sea in Puglia.

Michael A. Pagano  
Chicago

Robert Leonardi  
London

September 2006

## Notes

- 1 Ron Watts, "The Relevance Today of the Federal Idea," paper presented at the International Conference on Federalism, Saint Gallen, Switzerland, 2002. Paper accessed 15 August 2006, <http://www.forumfed.org/federalism/Watts.asp?lang=en>
- 2 John Kincaid, "Introduction" in Kincaid, Ed. *Handbook of Federal Countries: 2002* (Montreal and Kingston: McGill-Queen's University Press, 2002), p. 1.
- 3 Watts, op. cit.
- 4 Filippo Sabetti, *The Search for Good Government: Understanding the Paradox of Italian Democracy* (Montreal and Kingston: McGill-Queen's University Press, 2000), p. 242.

# Notes on the Contributors

**Robert Agranoff** is Professor Emeritus at the School of Public and Environmental Affairs, Indiana University – Bloomington. His work focuses on public and intergovernmental management and federalism. He is currently an associate editor of the *Journal of Public Administration Research and Theory* and chairperson of the Research Committee on Comparative Federalism of the International Political Science Association. Since 1990, he has been affiliated with the Government and Public Administration Program of the Instituto Universitario Ortega y Gasset in Madrid, Spain.

**Ann O'M. Bowman** received her PhD in political science from the University of Florida in 1979. Currently, she is the James F. and Maude B. Byrnes Professor of Government at the University of South Carolina. For seven years, she and Michael A. Pagano edited the Annual Review issue of *Publius: The Journal of Federalism*. She is co-author of *State and Local Government* as well as the 2004 book, *Terra Incognita: Vacant Land and Urban Strategies*. Recently her co-authored article, "Power Shift: Measuring Policy Centralization in U.S. Intergovernmental Relations, 1947–1998," appeared in *American Politics Research*.

**Jeffrey I. Chapman** is Professor of Public Administration and former director of the School of Public Affairs at Arizona State University. His doctorate in economics is from the University of California, Berkeley. His fields of specialization include state and local finance and the administration of financial resources. Dr Chapman has edited and authored several books including: *Pieces of Power – Governance in Arizona*, *Long Term Financial Planning: Creative Strategies for Local Government* and *Proposition 13 and Land Use: A Case Study of Fiscal Limits in California*. Scholarly journals and periodicals that have published his work include *Public Administration Review*, *Policy Studies Review*, *Public Budgeting and Finance*, *National Tax Journal*, *Journal of Urban Economics*, *The University of Southern California Law Review*, *Public Choice and Public Finance Quarterly*. His current research interests are state/local financial relationships and metropolitan fiscal heterogeneity.

**Susan E. Clarke** is Professor of Political Science at the University of Colorado at Boulder, Colorado US (PhD, University of North Carolina at Chapel Hill). Her research centers on local economic development, cross-border regionalism, the politics of workforce development, and policy reforms in higher education. In addition to numerous articles, her publications include *The Work of Cities* (with Gary Gaile). She is director of the Center to Advance Research and Teaching in the Social Sciences (CARTSS),



a campus-wide interdisciplinary program. She is currently Assistant Vice-Chancellor for Academic Affairs. She is on the Executive Council of the American Political Science Association and co-editor of *Urban Affairs Review*.

**W. Bartley Hildreth** is the Regents Distinguished Professor of Public Finance in the finance faculty of the W. Frank Barton School of Business and the Public administration faculty of the Hugo Wall School of Urban and Public Affairs, and director of the Kansas Public Finance Center, at Wichita State University. His previous business school appointments include Professor at Louisiana State University and Associate Professor at Kent State University (Ohio). In addition to over 100 articles, chapters and books, Dr Hildreth is the editor-in-chief of the *Municipal Finance Journal*, the only quarterly peer-reviewed journal devoted to municipal securities and state and local financing.

**Christopher W. Hoene** is the Research Manager at the National League of Cities (NLC) and Director of the Municipalities in Transition Program. He oversees and conducts NLC's research on municipal finance and federalism. He also leads NLC's *Future of Public Finance Initiative*, an effort designed to call attention to the challenges facing America's public finance system. Previously, he was a Policy Analyst with the Center on Budget and Policy Priorities in Washington, DC and a Research Fellow at the Public Policy Institute of California. He received an MA in public policy (1996) and PhD in political science (2000) from Claremont Graduate University.

**Daphne A. Kenyon** is Principal of D.A. Kenyon & Associates, a public finance consulting firm. Prior positions include president of the Josiah Bartlett Center for Public Policy, Professor and Chair of the Economics Department at Simmons College, senior economist with the U.S. Department of the Treasury and the Urban Institute, and Assistant Professor at Dartmouth College. Kenyon has been researching federalism, state and local public finance, and tax issues for over 20 years. She has published articles in a variety of journals and has co-edited two books: *Competition among States and Local Governments* (with John Kincaid) and *Coping with Mandates* (with Michael Fix).

**Robert Leonardi** is Director of the Economic and Social Cohesion Laboratory, European Institute, London School of Economics. He has been engaged in research on the politics and policies of the European Union, with a special emphasis on cohesion policy and the single market. His latest publication is *Cohesion Policy in the European Union: The Building of Europe* (2005).

**Sarah F. Liebschutz** is Distinguished Service Professor Emeritus of the State University of New York. She is a specialist in American federalism and intergovernmental relations, the author of four books and numerous acad-

emic articles and book chapters, monographs and reports for New York State and United State government agencies. Dr Liebschutz is a consultant to the Rockefeller Institute, leading studies of the effects of federal grants, recently welfare reform, on governments and non-profit agencies in New York State. She is a member of the editorial board of *Publius: The Journal of Federalism*.

**Raffaella Y. Nanetti** is Professor of Urban Planning and Policy in the College of Urban Planning and Public Affairs, University of Illinois at Chicago. Since 1998 she has directed the Great Cities London Program, UIC's flagship study abroad program for undergraduate and graduate students. She was a member of the study team that carried out the 20-year longitudinal study of Italian regional and local institutions (with Robert Putnam and Robert Leonardi) from which the concept of "social capital" was empirically derived ("Making Democracy Work", 1992). She has published extensively and guest lectured at universities in the USA, Europe and the Middle East. She holds degrees from the Catholic University of Milan (laurea in Political Science), Johns Hopkins University (International Relations), University of Illinois at Urbana-Champaign (Masters in City Planning), and University of Michigan (PhD in Urban and Regional Planning).

**Michael A. Pagano** is Professor and Director of the Graduate Program in Public Administration at the University of Illinois at Chicago, co-editor with Susan Clarke and Gary Gaile of *Urban Affairs Review*, and for seven years was co-editor with Ann O'M. Bowman of the Annual Review issue of *Publius: The Journal of Federalism*. He has published numerous articles and books on urban finance, capital budgeting, federalism, transportation policy, infrastructure, urban development and fiscal policy; his latest co-authored book with Ann O'M. Bowman was released in 2004 titled, *Terra Incognita: Vacant Land and Urban Strategies*. Since 1991, he has written the annual City Fiscal Conditions report for the National League of Cities. He earned a BA from the Pennsylvania State University and a PhD from the University of Texas at Austin.

**Filippo Sabetti** is Professor of Political Science at McGill University, Montreal, Quebec, Canada. His research and teaching interests focus on what difference alternative principles and systems of governance make in the way people collectively manage their affairs. His focus is on Canadian and American federalism and French, Italian and Spanish political development. He has, among others, co-edited a special issue of *Publius* and a book on Canadian federalism, and authored a much acclaimed book on Italian politics. His publications have also appeared in Catalan, Italian and Spanish. A past president of the Conference Group on Italian Politics & Society, Professor Sabetti was for many years an Adjunct Scholar of the Center for the Study of Federalism at Temple University. He is an Associate

Member of the Workshop in Political Theory and Policy Analysis, Indiana University, Bloomington.

**Celina Souza** is Professor of Public Administration and Research Fellow at the Centre for Human Resources, both at the Federal University of Bahia, Brazil. She is the author of *Constitutional Engineering in Brazil: The Politics of Federalism and Decentralization* (1997) and has written a number of journal articles as well made contributions to edited books both in English and Portuguese. Her most recent publications in English are “Brazil: The Prospects of a Center-Constraining Federation in a Fragmented Polity”, which was published in *publius: The Journal of Federalism*, Spring 2002 and “Participatory Budgeting in Brazilian Cities: Limits and Possibilities in Building Democratic Institutions”, which was published in *Environment & Urbanization*, April 2001.

**Carol S. Weissert** is the LeRoy Collins Eminent Scholar Chair of Civic Education and Political Science at Florida State University. Prior to taking that position in August 2003, she was Professor of Political Science and Director of the Institute for Public Policy and Social Research at Michigan State University. She has published over three dozen articles in political science and public policy journals and is author or co-author of three recent books including *Governing Health: The Politics of Health Policy*, the second edition of which was published in 2002. Dr Weissert earned her doctorate in political science from the University of North Carolina at Chapel Hill.

# 1

## In the Eye of the Beholder: The Dynamics of Federalism in National and Supranational Political Systems

*Michael A. Pagano*

The established federal polities in the world have evolved over decades and centuries, through political upheavals and wars, through continual pressures that tug toward more centralization and pull toward greater local autonomy, and through their capacity to morph and change to new circumstances and challenges. In response to internal demands and external forces, federal polities have adapted to these pressures by rewriting constitutions and laws, engaging in civil disobedience and violence, establishing fundamental human rights, revising fiscal systems, reconfiguring programmatic and service-delivery responsibilities, and in all other manner negotiating and bargaining in order to sustain the strengths of the federal system over time. Indeed, understanding how federal systems have adapted to changing environments over time and how they have adjusted to myriad challenges provide important insight into reform efforts in the political world today.

This book highlights two important factors in understanding federal structures and the choices that polities might confront as they are challenged to re-adjust and re-align their political systems. One is the effects of the passage of time and historical events that condition the political, legal, fiscal and policy environment of federal systems; the other is time's related counterpart, change, and federal systems' responses and adaptation to fluid political situations.

### **Introduction**

Since the fall of the "iron curtain" in 1989 and the end of decades-long oppression in others, emerging democracies and established democracies alike began searching for new or innovative constitutional organizing principles around which to reinvigorate their nation's polity, economy, and civic life. The answer to many of the real and perceived ills of both emerging democracies and established democratic nations with federalism aspirations seemed to reside in the lessons and experiences of long-standing

federal polities, such as the United States, Canada, Switzerland, Germany, Australia, and India.<sup>1</sup>

The European Union, for example, pressed for increasing institutional linkages in a confederation that, over time, began to resemble other established federal polities with an identifiable “center” and constituent units. Russia, now that it has abandoned a rigidly centralized command-and-control political economy, looked toward a decentralized political system to both keep the remaining constituent units of the nation together and maintain its reputation as an important international player.<sup>2</sup> Emerging nations, such as South Africa, Czechoslovakia (whose velvet revolution ended in divorce), and the on-again, off-again power-sharing proposals between Palestine and Israel, found in federal structures something that could help bind a nation or region together politically, economically, socially and militarily.<sup>3</sup>

Calls for greater local autonomy in centralized polities, such as in Italy, the United Kingdom, Mexico and Spain, are clear signals that decentralized power, local autonomy and control, and fear of the pernicious effects of centralizing ambitions are on the ascendancy throughout the world. Yet, political adjustments, such as those that “lean toward” federalism, or aspirations to some sort of federal structures should not be understood as always having been successful. Nigeria is an unfortunate case in point. Notwithstanding a few setbacks in the march toward federalism, the decade of the 1990s might be described as the era of federalism’s reawakening, while the 21<sup>st</sup> century might be destined to be federalism’s *secolo d’oro*, its gilded age, the finest hour.<sup>4</sup>

If “federalism” had become the shibboleth of political reformers in the late 20<sup>th</sup> century and early 21<sup>st</sup> century, there is little agreement on just what exactly constitutes and defines a federal system or on what political reformers were trying to design. The form and operations of new federal systems as well as the continually-adjusting older federal systems provide many types of federal systems to choose from. For those nation-states that were successful in moving away from a unitary or centralized system and toward a federal system, the next hurdle is to answer the question, which federalism?

The patchwork quilt of the variations in federal systems is captured in Watts’ comprehensive report on comparative federal systems (Watts 1999). In *Comparing Federal Systems*, he proposes the following definition of federal polities:

The generally common structural characteristics of federations as a specific form of federal political system are the following:

- two orders of government each acting directly on their citizens;
- a formal constitutional distribution of legislative and executive authority and allocation of revenue sources between the two orders of government ensuring some areas of genuine autonomy for each order;

- provision for the designated representation of distinct regional views within the federal policy-making institutions, usually provided by the particular form of the federal second chamber;
- a supreme written constitution not unilaterally amendable and requiring the consent of a significant proportion of the constituent units;
- an umpire (in the form of courts or provision for referendums) to rule on disputes between governments;
- processes and institutions to facilitate intergovernmental collaboration for those areas where governmental responsibilities are shared or inevitably overlap (Watts 1999: 7).

To illustrate the complexity in defining federal systems, Watts assigns over 70 nations to one of the nine “types” of federal polities first identified by Elazar in his “Typology of Federal Political Systems” (see Table 1.1) (Elazar 1994b: xvi). The typology could easily be expanded today, over a decade later, by recognizing regional asymmetric traits such as those in Portugal with Madeira and Azores and also in the United Kingdom with Scotland,

**Table 1.1** Elazar’s typology of federal political systems

- 
1. Confederation (pre-existing polities join together to form a government for strictly limited purposes, e.g., European Community, the States under the Articles of Confederation);
  2. Federation (a polity compounded of strong constituent entities and a strong general government – e.g., US, Canada);
  3. Union (a polity compounded in such a way that its constituent entities preserve their respective integrities primarily through common organs of the general government rather than through dual government structure – e.g., Italy, Spain, Burma);
  4. League (a linkage of politically independent polities for specific purposes that function through a common secretariat rather than a government, and from which members may unilaterally withdraw – e.g., British Commonwealth, Arab League);
  5. Consociation (a non-territorial federation in which the polity is divided into permanent transgenerational religious, cultural, ethnic or ideological groupings federated together and jointly governed by coalitions of the leaders of each);
  6. Federacy (an asymmetrically linked larger and smaller polity in which the smaller polity has substantial autonomy and minimal role in governance of the larger power, and the relationship can end only through mutual agreement – e.g., US–Puerto Rico, Portugal–Azores, India–Kashmir);
  7. Associated state (an asymmetrical arrangement similar to federacy but it can be dissolved unilaterally – e.g., Netherlands–Netherlands Antilles);
  8. Joint functional authority (an agency established by two or more polities for joint implementation of a particular task); and
  9. Condominium (a polity ruled jointly by two powers in such a way that the inhabitants of the polity have substantial internal self-rule – e.g., Andorra).
-

Wales and Northern Ireland, or by recognizing evolving local and regional autonomous zones, such as those developing in Spain. Nevertheless, it is the rapidly expanding variety of federal systems to which Elazar and Watts call attention.

The typology of federal political systems gives rise to further assessment and exploration of what constitutes the core features of a federal system. One such characterization of federal systems rests principally on the degree of autonomy that constituent units enjoy within the political system. Riker, for example, defines a federal system as one that consists of (1) a “hierarchy” of governments that delineates the scope of authority of each level, and (2) a level of autonomy of each level (Riker 1964a). Linking the economic role of the state with a political system, Weingast builds on Riker’s definition of a federal system and develops what he calls a “market-preserving federalism” (Weingast 1995). He includes three additional features: (1) “subnational governments have primary *regulatory responsibility over the economy*”; (2) “a common market is ensured” as a mechanism to prevent trade wars, and (3) local governments cannot print money or have easy access to unlimited credit, or what he calls a “hard budget constraint” (Weingast 1995: 4). Weingast’s argument is that these features of a federal republic create conditions of competition among lower units of government – an argument first articulated over a half century ago by Tiebout (1956) – and discourage fiscal profligacy by not allowing bailouts. These conditions, he contends, created the strongest global economies in 18<sup>th</sup>-century England, 19<sup>th</sup>-century US, and present-day China.

Elazar’s principles of American federalism reflect Watts’ and Riker’s institutional perspective by emphasizing national supremacy of the central government and the broad authority of Congress to legislate and appropriate money (Elazar 1984). But Elazar goes further and emphasizes the role and importance of “non-centralized” government with maximum local control as a critical factor in explaining the strength and vibrancy of the American federal system. The capacity to adapt to changing political and social circumstances arises systemically in a federal system that encourages and enshrines partnerships between and among levels of government.

Delineating the scope of authority, as Riker states, has led scholars and politicians to “sort out” the proper division of authority between the federal and state governments, and between states and their local governments. Peterson, in *The Price of Federalism* (1995), reiterates a basic premise he advanced in *City Limits* (1981), namely, that programs and policies with spillovers or externalities are inappropriate for local governments to assume and ought to be shouldered by “higher” level governments – meaning, governments with broader territorial jurisdiction. Otherwise, states and local governments with generous redistributive programs (e.g., welfare) will attract potential beneficiaries and drive away potential contributors or taxpayers (Peterson and Rom 1990). In the US, the discourse on sorting out

has not met with much satisfaction at the practical plane. All levels of government are involved to a certain degree with primary and secondary education, public safety, transportation, and – especially post-9/11 – even with national defense. Each level assumes a more or less dominant role in each of these policy arenas, yet often requires substantial participation by and cooperation with another level.

The notion of federalism as a system of divided powers is challenged by some who view it in procedural terms. Glendening and Reeves, for example, consider a federal system as one in which relations among levels of government are “flexible, fluid, and pragmatic, ever changing and adjusting with shifts in power loci and public attitudes” (Glendening and Reeves 1977: 8). In other words, federal systems are dynamic, as power shifts along the edges and contours of the sovereign or autonomous units.

Inherent in federal systems, we expect to find and possibly encourage competition among governmental units.<sup>5</sup> The capacity of these governments to compete effectively with one another depends on the amount and degree of legal and constitutional autonomy, fiscal authority, and political willingness to stretch the reach of their coercive powers. The effectiveness of local government’s competition depends in many ways on its ability to exact revenue, the extent of its natural and human resource endowment, the type and form of political culture, and other community-specific economic, political and social factors. Successful competition in enhancing the human condition, promoting the general welfare, and protecting life and liberty requires differentiated communities to establish institutions imbued with such purposes. To the extent that local governments’ fiscal and service-delivery systems are designed to promote the human condition, the ensuing competition among jurisdictions is thought to be healthy in promoting efficient and effective services.

At the same time that state and local governments are encouraged to compete one with another for the purpose of generating efficiency gains, they also frequently behave as oligopolists and collude in distributing services in order to hold down “destructive competition.” The argument presented in this case turns, to some extent, on the inefficiencies inherent in a multiplicity of local governments within a region each funding duplicative institutions. In other words, the counter-proposal to the advice “promote interjurisdictional competition” is that consolidating service-delivery systems should generate savings due to economies of scale of larger organizations (of course, recognizing that the efficiency gains in organizations beyond some size become negative).

To address these concerns, regional structures and institutions are at times proposed to coordinate and harmonize region-wide solutions to policy problems such that the constituent communities do not behave at cross-purposes, such as planning a highway through a sensitive ecological system, or at least to minimize the variation in service-levels delivered to



citizens within a region (Jones 1942; Studenski 1930; Ross and Wikstrom 2000). A set of intergovernmental structures are then designed to eliminate redundancies across local governments within a well-defined region and to harmonize region-wide policy solutions. The regional government creates rules, regulations and incentives for efficient and effective service delivery systems and offers an attractive bundle of services at a politically-acceptable tax-price.

The yin and yang of these regional and intergovernmental structures are the constant and continuous ebb and flow of a tug toward more centralization of service provision and the pull toward more decentralized service delivery. Administrative structures reflect the kind and type of participatory democracy a society deems reasonable as well as the command and control features of service delivery, reflecting now local, now central control.

That “federal polities” might mean different things to different people at different points in time is hardly surprising, given the plethora of federal systems. The reach of central powers and the carving out of state/provincial spheres of influence vary considerably among the nations that Watts assigns to different federal polity types. Yet, these various configurations have important implications for legal and constitutional questions, financial relationships and fiscal powers, and service-delivery responsibilities within an intergovernmental system. And they certainly beg the broader question of which federal systems have evolved and survived. With particular emphasis on the federal system of the United States, the collection of papers in this volume demonstrate and highlight the dynamic and changing nature of federal political systems, in particular their resilience and flexibility in adapting to new-found pressures and problems.

The genius of a federal system is found in Justice Louis Brandeis’ assessment that states are “laboratories of democracy.” As experiments are conducted, states learn to adapt to their new environment and to borrow from the successful ones. The notion that states are “laboratories” implies that they are dynamic, that they learn, and that, in order to survive, they must adapt.

## **Images of federal polities**

Like boxes and arrows of an organization chart, legal and institutional relations among levels of government in a federal system have been conceptualized by federalism scholars. A common presentation of intergovernmental administrative structures places the central or general government in a position of absolute authority and power. States or provinces are delegated certain responsibilities and their powers can often be shaped by central government intervention. The administrative structure in this intergovernmental system is clearly hierarchical, with powers of the constituent units severely circumscribed by central government authority. Sometimes referred

to as the “inclusive authority” model of federal systems (Wright 1988), the extent to which this form of federalism conforms to typical norms of federalism is limited.

A second image of intergovernmental structure is based on a clear understanding of the spheres of influence over which distinct levels of government have control and authority. This form has been described as the “coordinate authority” model or “nested” levels of government. Powers of governments within each level are negotiated with each partner and overlapping powers in particular require constant renegotiation among the partners. For example, US cities’ revenue structures depend in part on state authority to grant access to revenue sources as well as on state and local limitations over their taxing authority. Cities’ fiscal structures can be thought of as being “nested” within a constitutionally constructed system that influences and constrains cities’ relative autonomy in a federal system. Revenue access, functional responsibility, and legislative authority of municipalities and other local governments are *guided* by the rules and regulations of the higher-order governments, their states and the federal government. An understanding of the administrative relationships among and between levels of government, from this perspective, derives from the constrained choices of one level of government imposed on it by other levels of government.

The administrative structure of this coordinate authority model is somewhat fluid, depending on the policy arena requiring intergovernmental coordinating offices. Incentive structures to secure compliance by the central government include regulatory statutes, grants-in-aid, and investment leveraging.

A decidedly non-central orientation to federal structures – a third image – has also been proffered by emphasizing the *local*. Much of the literature on federalism and federal structures has become imbued with a bottom-up perspective necessitating a decidedly non-central orientation. The image of a non-central model of federalism includes the coordinate authority model with tighter/looser overlapping areas of responsibility *and* horizontal linkages and cooperative/competitive arenas across local governments. Increasingly, as urbanization and sprawl have expanded the physical size of metropolitan areas, local governments are influenced by their constitutional relationship with “higher” levels of government and also by their political and economic relationships with “horizontal” levels of government, that is, with other local governments and non-profit organizations within a spatially-defined area.

Yet, these standard images of federal structures, along with other now-common presentations of federal-state and federal-state-local relations (e.g., layer-cake, marble-cake, picket-fence, silos), overlook or understate the impenetrable complexity of hyper-fragmented political systems, such as exists in the US. Students of urban politics use metaphors such as “splintering” urbanism

(Graham and Marvin 2001) to describe the deconcentration and decentralization of metropolitan regions. The metaphors convey a sense that the metropolitan political system, especially in the US, is extraordinarily difficult to sort out and understand. Indeed, the complexity of many federal systems rivals that of metropolitan regions. As such, it might be likened to a 3-dimensional plexiglass puzzle with each of the three levels representing the federal, state and local governments.<sup>6</sup> Each level can be discerned by a perceptive viewer and even some of the pieces of the puzzle within each level can be identified, but matching all the pieces to the three levels becomes a tedious and challenging task. One reason is that one of those levels (the local level) consists of sometimes a half dozen sub-levels (e.g., municipal corporations, transit districts, counties, school districts, mosquito-abatement districts). Indeed, choices in attempts to assemble the puzzle are often wrong. The city is blamed for the school system's high dropout rate in states in which public schooling is a special district responsibility. The municipal corporation is blamed for inadequately-maintained state streets that traverse the city but are a state responsibility. The state is blamed for "wasting" taxpayer money on state-of-the-art prisons, when it is the federal court that orders such enhancements.

Consequently, petitions to "the government" are often presented at the wrong level, making it difficult to achieve any accountability. Some scholars see this lack of accountability as a deliberate, and almost diabolical, issue. The public choice literature refers to this problem as "fiscal illusion," which contends that the actual costs of producing goods can be hidden from taxpayers through a variety of mechanisms (Logan and O'Brien 1989; Cullis and Jones 1987). Bureaucrats, as rational, self-interested individuals, do not reveal true costs or benefits of programs and instead exaggerate benefits and impacts. Because they, like their private sector counterparts when they negotiate with government agencies over the price of contracting, possess information that is either unavailable or difficult to retrieve by legislators and the general public, funding levels for those government agencies tend to be unrelated to any objective measure of performance. Moreover, it is to the advantage of agencies and bureaucrats to maintain confusion in the minds of voters and legislators about service delivery responsibility and tax burden. Blame for service failure can be deflected to other overlapping agencies and other bureaucrats. Citizens and their representatives, without this knowledge or information, make uninformed and thus inefficient choices.<sup>7</sup>

The challenge to democratic and newly-democratizing nations is to sort through the 3-dimensional puzzle and assess the evolving power relationships between the center and periphery. Matching the needs and priorities of the citizens with the appropriate level of government will most certainly generate a heterogeneous landscape of federal systems across the globe. The administrative structure in such federal systems involves a complex set of agreements between and among local governments as well as between local governments and the state and federal governments.

## Essentials of federal systems

Through time, these forces that tug and pull toward centralization and decentralization produce political systems that emphasize some features of federal polities at one time and other features at other times. The dynamic changes over time inform and instruct on the multiplicity of federal possibilities and simultaneously lead observers to wonder which type of federalism is at work today.

### The constitutional and political framework

Three organizing frameworks can be culled from the myriad studies on federal structures. The first is the constitutional and legal framework. No polity can survive the vicissitudes of groups and individuals bent on seizing power violently or on exercising the coercive powers of the state without the express approbation of the citizenry. Clear constitutional principles require nations to establish and control the reach of the central government, the rights of its citizens (e.g., Riker 1964b; Howard 1996; Kincaid 1995), and the relationship between and among the constituent units (e.g., states, provinces, regions). These have been the traditional concerns of a legalistic framework for promoting federal structures, especially those intending to promote a federal system as a means to protect civil rights. But those concerns have evolved in scholarly circles to acknowledge the intertwining of realms that were once considered purely political (of the state) and those considered purely private (of the market). The symbiotic relationship between the two sectors, in addition to the increasing importance of the not-for-profit or non-governmental organizations in the public life of societies, has given rise to the concept of governance.

The focus on governance within a constitutional system does not necessarily support the creation or expansion of a federal system. Rather, federal structures allow for a larger set of participants and actors than a unitary or centralized system that in turn arguably enhance political participation, protection of human rights, and a better alignment of needs with resources (Beer 1993). Use of the constitutional and legal framework to advance the human condition requires a framework that more accurately and realistically incorporates the various agencies and stakeholders.

Recognition of the multiple and interactive opportunities within a federal system allows access to various "levers of power" whether within the state sphere or the federal sphere (or even within the local government sphere for federal systems that have devolved power and authority over certain functions). This Constitutional and Legal framework, then, extends beyond mere constitutional issues and stretches to include the broader governance structure of the federal system. The governance environments of federal systems are rich, robust, dynamic and provide a foundation for citizens and their governments to engage in and change their relationships one with another.

### **The fiscal framework**

Second, the lifeblood of any functioning government is its system of finances or what Hamilton called in *Federalist* #30 “the vital principle of the body politic.” These fiscal systems are developed on the backs of economic systems, requiring the fiscal architects to match the levers of revenue extraction to the engines of economic growth. The capacity, then, of any level of government to create a suitable fiscal system that matches both the preferences of the citizens and the growth-engines of a government’s underlying economic base is dependent on the level of fiscal autonomy enjoyed by each level of government. The authority to tax certain activities and raise own-source revenues, to issue debt for capital projects, and to ensure a fair and efficient system of public finance rests on both a constitutional frame as well as on an intergovernmental system of fiscal relations.

The intergovernmental public finance system provides direct linkages between governments – federal, state, and local – and the people, collecting revenue and providing services. The evolving conditions of the fiscal system are critical to analyze as the economic and social systems of polities change. Those fiscal systems that are incapable of adjusting to these new conditions threaten to undermine each level of government’s ability to enhance the human condition. Those that adapt, and are allowed to adapt if controlled or influenced by another level of government, then create public finance systems that are less likely to distort the market economy. Concentrated tax burdens on one segment of the economy or on one group can distort the market, which a fair and efficient public finance system should avoid.

In the debates to ratify the US constitution, a battle raged between those who believed that the central government’s power to tax would impede the states’ powers to tax. If both could tax the wealth of the same individual, the fear was expressed that the advantage to the central government would supersede the authority of the states. Although Publius, Alexander Hamilton’s *nomme de plume* on this issue, dismissed this fear by arguing that an individual’s loyalty would be to the state because of its role as defender of life and property, the issue highlights the overwhelming importance of fiscal control over the various governmental levels in federal polities.

### **The policy framework**

The third organizing principle is the policy relationship between central and state authorities. As Wright (1988), Anton (1989), Zimmerman (1991), and others make abundantly clear, the relationship between states and the central government is a function of the degree to which spheres of policy influence overlap each other or are separated by fire walls. The more that both the state and the central government exercise authority and influence in the same arena, the more a cooperative relationship will characterize their interactions.

Yet, if the regulatory reach of one level of government – typically the federal government – is not controlled, the sovereignty of the regulated government is compromised. This type of regulatory federalism has been referred to as “coercive federalism,” a term denoting not just that states have become unwitting and possibly inferior partners in a new federalism environment but that a concomitant loss of sovereignty and autonomy accompanies such action (Kincaid 1993).

The establishment of specific powers of the federal government as enumerated in Article I, section 8 of the US constitution was initially designed to constrain the potential reach of federal powers. This concern continues to be raised periodically by politicians and academics under the rubric no longer of divining the “enumerated powers” of the federal government but by more rationally “sorting out” the appropriate or best responsibilities of each level of government. By limiting the overlapping powers of all levels of government, the prospects for one government’s stepping on the sovereignty of another’s are diminished – or so argue the adherents. Although this approach is intellectually appealing, the numbers of increasingly complex networks of administrative, service-delivery, and decision-making bodies that control some aspect of many or most “government services” are staggering and growing.

Consequently, the resulting complex network of institutional relationships needs to be clearly understood as federal systems assign policy responsibilities, construct intergovernmental organizations to manage these interrelated activities, and respond effectively to the demands and policy preferences of the citizens.

## **Outline of the book**

This book is designed around the three organizing principles outlined above as well as around the understanding that political systems are dynamic, adaptable, and change over time. The chapters in this book provide a temporal perspective on a key element of federal politics. This is not a cross-national or comparative assessment of federal systems.<sup>8</sup> Rather, the chapters herein examine the dynamic, temporal shift in the legal, fiscal and policy environments of federal systems with particular focus on the US.

The chapters in this book examine the dynamic, adaptive features of federal systems that, after experiment upon experiment have left their imprint, but then have moved on to the next stage of evolutionary adaptation. Just exactly what that type of federalism is cannot be fixed in the firmament and left forever unchanged. Which kind of federal system to be pursued depends on the situation, on what has been learned from previous experiments in the political-economic and social environment, and on the visions of people and their leaders.

The genesis of the project that resulted in these papers was the changes to Italy's constitution in 1999. The debates over the exact form and function of the nascent federal system indicated that nearly anyone who has thought about a federal system held a different view of what exactly a federal system was. This confusion surrounding the contours of federal system lent itself to the theme of the conference, "Which Federalism?"<sup>9</sup>

### **The constitutional and political framework**

In the first part of the book, *The Constitutional and Political Framework*, three chapters focus on the political and social relations within federal polities that are governed by the constitution and the interpretation of constitutional relations between levels of government.

In Chapter 2, "Types of Federalism: Achieving Self-governing Capabilities in Societies with Federal Potentials," Filippo Sabetti defines the key characteristics of federal systems, including the rights of citizens within the federal framework. Taking as a point of departure the two federal and legal systems in North America, he explores democratic development in 19<sup>th</sup>-century Europe. Sabetti discusses why some of the best European minds – Tocqueville, Cattaneo, Ferrara and Cavalieri – turned their attention to the theory and practice of North American federalism to justify and support the extension of self governing capabilities in their own countries, and why such attempts did not generate the desired results immediately. This lack of success paradoxically served to keep alive the prospect of federal constitutional options in the future. The historical argument developed suggests how we can think theoretically and comparatively about the contemporary question of which federalism.

Susan Clarke introduces governance and leadership as critical variables in contemporary federal systems in Chapter 3, "'Thinking Federally' from a Governance Perspective." From a governance perspective, *governments* are increasingly interdependent with other public and private actors – *governance* processes therefore require that actors seeking mutual gains find ways to coordinate their efforts. Thinking of federalism from a governance perspective moves beyond a state-centric approach to federalism to reflect the distinctive decision contexts and constraints facing public leaders. It highlights the leadership tasks demanded by these new contexts and the normative issues of accountability, legitimacy, and sustainability. But lack of precision in the conceptualization of governance processes – especially network strategies – limits our ability to construct more analytic, less descriptive, accounts. Consequently, there is a weak base of systematic, persuasive evidence that governance arrangements are effective, efficient, and equitable in producing desired outcomes. Some of the most important federalism issues in coming years will, she argues, have to do with governance dilemmas. Therefore, clarifying the strengths, difficulties, and opportunities created by governance arrangements is an important priority.

Recognizing that political boundaries are artificial constructs of competing polities or natural barriers, Ann Bowman's chapter, "Social Forces, Space and Boundaries," is about space and boundaries and, somewhat more indirectly, social forces. The issue driving her analysis is how we divide space to create jurisdictional borders, and what impact these boundaries have. The focus is on US states: states as political systems, states as communities of interest, states as bounded territories. Thus the topics covered include the division of space at the nation's founding, the persistence of sectionalism, the role of political culture in public policy, the redrawing of state boundaries, and the use of border spanning mechanisms. It poses the question of whether space can be reconfigured into meaningful regions.

### **The fiscal framework**

Polities survive to the extent their revenue-raising authority is efficient, adequate and equitable. The second part of the book, *The Fiscal Framework*, examines the evolving economic and tax systems of federal systems, with particular attention on the role of transfers, redistribution, and local (own-source) revenue structures in the US.

Jeffrey Chapman examines the degree to which a nation's wealth and tax systems converge. In Chapter 5, "Wealth and Tax Systems," he examines how a federal system of government can address changes in its economic environment. First, he discusses the broadly defined tax assignment problems in federal systems. He identifies potential tax bases, tax rates, and intergovernmental transfers as answers to these problems. This section also notes theoretical as well as practical solutions to assignment problems. In the second part, he identifies a multitude of changes in the revenue raising abilities of subnational governments in a federal system. Finally, he identifies subnational governments' responses to changes in a theoretical framework of hard- and soft-budget constraints. Examples of both state and local experiments to offset these changes are noted. Included in this part is a description of interjurisdictional competition and the potential of corruption in a federal system. Chapman then draws some lessons and recommendations.

State and local governments generate revenue to support their services from three basic sources. Two that are controlled by the state or local government in the US are own-source revenues and debt. In "Local Government Own-source Revenues and Debt Financing: Structure and Stress" W. Bartley Hildreth assesses the adequacy and effectiveness of general tax revenues over which governments have control and authority, as well as the authority to issue debt. Fiscal federalism carries the obligation to bestow as much autonomy over local fiscal choices as possible. This power should include the ability to design, levy, collect and use locally incurred taxes. A counterpart to the power to tax is the power to incur debt. Debt



imposes a future obligation on taxpayers or ratepayers to generate sufficient revenues to cover the debt service. In essence, debt securitizes future revenue flows. Thus, the political and economic choices embodied in local tax structures influences both tax policy and debt policy.

Tax structures, argues Hildreth, are not static. Rather, they are revised frequently to adapt to changing circumstances. The stress on tax policy derives from the tax structure and its effects. This portfolio of political and economic choices suggests the value of a tool such as the proposed tax policy stress indexes.

The third revenue source for state and local governments is aid from another level of government, the federal government. Central governments form financial linkages with states and other local governments. In Chapter 7, "Fiscal Federalism and Intergovernmental Revenues in the US," Christopher Hoene presents the theoretical rationale for federal resource transfers, the empirical evidence of such transfers over time as the federal and state governments experiment with a host of grants and regulations, and the impacts of those transfers on constituent units of a federal polity.

Which federalism might we expect in the future? What will the fiscal framework that underlies that federalism look like? Hoene examines these questions in a historical context through an analysis of intergovernmental transfers in the American federal system over the last century, focusing particularly on the last three decades. Arguing that the single defining characteristic of the system is its messiness, he traces well-documented changes in the American federal system and the implications of those changes for intergovernmental relationships. Intergovernmental transfers among federal, state, and local governments are analyzed using data from the Government Division of the US Census Bureau and documents based on that data. Based on his analysis, Hoene concludes: (1) intergovernmental transfers from federal to state governments and federal to local governments increased dramatically in the 1960s and 1970s as a result of programs expanding the federal government's role; (2) federal transfers to state and local governments declined in the 1980s as a result of policies enacted under the Reagan administration; (3) growth of intergovernmental transfers resumed again in the 1990s, driven primarily by increases in payments for individuals; (4) state transfers to local governments have remained stable over time, and (5) increases in federal mandate and preemptions, along with the rise of tax and expenditure limitations, makes reductions in intergovernmental transfers more difficult to bear at the state and local level. The chapter concludes that the intergovernmental trends of the past two decades are continuing today, with less focus on federalism and intergovernmental relations, and more focus on reducing the size of government – or less federalism.

## The policy framework

Federal systems organize governments to reflect the will of the people at two levels, the local (state) and the general (central). These governments organize to provide services to satisfy the needs and demands of the citizens. In federal polities, the service-delivery systems constitute a vast and complex network of institutions and organizations, which is the subject of the third part of the book, *The Policy Framework*.

The first chapter in this part, by Carol Weissert, articulates the sorting out of roles and responsibilities among levels of government within a federal system by assessing theoretical frameworks and by examining contrasting cases. In “Dividing the Job Revisited: Learning from the United States Case 1789–2006,” Weissert argues that the division of powers among national and state governments in the United States has been analyzed, critiqued, and targeted for reform for generations. Anton argues that the “essential federalism question is which government should undertake which activity, and on whose budget?” (Anton, 1989: 10). Few disagree that the issue is important and crucial to the understanding and implementation of federalism. But what is that division of power and can it be categorized for use by politicians and other policy-makers? Weissert analyzes the history of attempts to answer the question “what government should do what” in a federal system and the frustration on the part of both academics and practitioners in the shortcomings of early answers. It poses another way of looking at this essential federalism question by recognizing the relevance of such issues as politics and policy dynamics.

Daphne Kenyon examines the array of government responsibilities or functions and the public sector as producer of services (namely, governmental, non-profit, private organizations) to assess their efficiency, effectiveness and equity in service delivery. In Chapter 9, “Efficient and Equitable Service Delivery in a Federal System,” she argues that just because government has the responsibility for providing a good or service does not mean government necessarily has to produce that good or service. Kenyon examines service-delivery alternatives that have been tried by state and local governments in the US and searches for the lessons that can be learned. Service-delivery alternatives include contracting out, competitive sourcing, franchising, grants, vouchers, and public-private partnerships. She also considers the pros and cons of using government, private for-profit firms, or non-profit firms to deliver government services.

A theme that runs throughout the literature on service-delivery alternatives is the benefit of moving from a non-competitive to a competitive structure for making service-delivery choices. State and local governments in the US make the most use of contracting out. Local governments contract with non-profit firms for health and human services and cultural and arts functions, whereas they contract with for-profit firms for public works and support services.

How intergovernmental policies are successfully implemented is the subject of Robert Agranoff's chapter, "Intergovernmental Policy Management: Cooperative Practices in Federal Systems." The focus is on the processes and mechanisms of policy coordination and cooperation across the boundaries of governmental units within federal countries. The 20<sup>th</sup> century was a time of growth and redefinition of welfare states, generating high degrees of intergovernmental interactions. In federal systems and systems with significant federal features a tradition of non-prefectural autonomy prevails at subnational levels, leading to relatively complex intergovernmental relations and management. Agranoff identifies the major mechanisms of "macro" relations and such emergent cooperative mechanisms as ministerial conferences, joint policy-making and horizontal federalism. Then the topic of "micro" managerial practices are identified, such as information and discretion-seeking activities, as well as horizontal exchange and project efforts.

Policy cooperation is examined through the lens of toxic waste disposal in the United States and by examining how managers at the local level in the US package different intergovernmental programs in economic development. Next, horizontal service and policy networks are identified as mechanisms of cooperation. In the conclusion, Agranoff suggests that these intergovernmental management processes are less visible than legislative, executive and judicial actions but have become a fourth "pillar" of governing, if not of government.

### **Federalism's temporal dimension**

In the last chapter, Robert Leonardi and Raffaella Nanetti ("Thinking About Federal Systems in the 21<sup>st</sup> Century in Light of the European Experience with 'Operational' Federalism") reflect on the trend toward establishing and designing federal polities or polities with federal-like structures. That a standard definition of federalism is absent provides ample opportunity to debate "which federalism" a polity pursues. Yet, there is no question that the ascendancy of federal structures will continue to be the hallmark of democratic societies everywhere.

In this volume, each of the scholars examines a small, but integral, slice of the critical elements that frame federal systems. This analytic slice, however, is also a temporal one that allows the reader to understand the evolving and adaptive nature of dynamic federal systems to changes in the underlying political, social, and economic systems. As political systems search for better governing and governance mechanisms and a better democratic process, as they debate which type of federalism best meets their own situation, the lessons from the contributors to this volume are intended to provide insight into the temporal context of historically important events. No one federal structure is recommended as the "silver

bullet" for all societies' political ills. These essays do not tell "which federalism" is the preferred option, for federalism, like beauty, really is in the eye of the beholder. Nevertheless, the debates over what federalism is designed to produce will, we hope, be enriched by the book's collective contribution and perspective.

## Notes

- 1 See, *inter alia*, Samuel H. Beer, *To Make a Nation* (Cambridge, MA: Harvard University Press, 1993); Daniel Elazar, *Exploring Federalism* (Tuscaloosa, AL: University of Alabama Press, 1987); Daniel Elazar, *American Federalism: A View from the States*, 2<sup>nd</sup> edn. (New York: Thomas Y. Crowell Company, 1984); John Kincaid, "Values and Value Tradeoffs in Federalism," *Publius* (Spring 1995), 29–44; Ann O'M Bowman, "American Federalism on the Horizon," *Publius* 32:2 (Spring 2002), 3–22; Celina Souza, "Brazil: The Prospects of a Center-Constraining Federation in a Fragmented Polity," *Publius* 32:2 (Spring 2002), 23–48; David Cameron and Richard Simeon, "Intergovernmental Relations in Canada: The Emergence of Collaborative Federalism," *Publius* 32:2 (Spring 2002), 49–72; J. Isawa Elaigwu, "Federalism in Nigeria's New Democratic Polity," *Publius* 32:2 (Spring 2002), 73–96; Thomas Fleiner, "Recent Developments of Swiss Federalism," *Publius* 32:2 (Spring 2002), 97–124; Kathryn Stoner-Weiss, "Central Governing Incapacity and the Weakness of Political Parties: Russian Democracy in Disarray," *Publius* 32:2 (Spring 2002), 125–46; Brian Galligan and John S.F. Wright, "Australian Federalism: A Prospective Assessment," *Publius* 32:2 (Spring 2002), 147–66; John S.F. Wright, "Anglicizing the United States Constitution: James Bryce's Contribution to Australian Federalism," *Publius* 31:4 (Fall 2001); F.L. Morton, "The Effect of the Charter of Rights on Canadian Federalism," *Publius* (Summer 1995), 173–88; Robert Vipond, "Seeing Canada Through the Referendum," *Publius* (Summer 1993), 39–56; Kenneth Wiltshire, "Australia's New Federalism: Recipes for Marble Cakes," *Publius* (Summer 1992), 165–80; Martin Painter, "The Council of Australian Governments and Intergovernmental Relations," *Publius* (Spring 1996), 101–20; Richard Deeg, "Economic Globalization and the Shifting Boundaries of German Federalism," *Publius* (Winter 1996), 27–52; Ronald Watts, "Canadian Federalism in the 1990s: Once More in Question," *Publius* (Summer 1991), 169–90.
- 2 See, e.g., Nicholas J. Lynn and Alexei V. Novikov, "Refederalizing Russia: Debates on the Idea of Federalism in Russia," *Publius* (Spring 1997), 187–204; Robert Sharlet, "The Prospects for Federalism in Russian Constitutional Politics," *Publius* (Spring 1994), 115–27; Gregory Gleason, "The Federal Formula and the Collapse of the USSR," *Publius* (Summer 1992), 141–64.
- 3 See, e.g., Brian Dollery, "An Initial Evaluation of Revenue-Sharing Arrangements in the New South African Fiscal Federalism," *Publius* (Spring 1998), 129–54; Nico Steytler and Johann Mettler, "Federal Arrangements as a Peacemaking Device During South Africa's Transition to Democracy," *Publius* 31:4 (Fall 2001); Richard Simeon and Christina Murray, "Multi-Sphere Governance in South Africa: An Interim Assessment," *Publius* 31:4 (Fall 2001).
- 4 See, e.g., "Toward Federal Democracy in Spain" (entire issue) *Publius* (Fall 1997); Alain-G. Gagnon and Guy Lachapelle, "Quebec Confronts Canada," *Publius* (Summer 1996), 177–92; "Federal Systems in the Global Economy," (entire issue) *Publius* (Winter 1996); "Federalism and the European Union" (entire issue) *Publius* (Fall 1996); John Kincaid, "The Devolution Tortoise and the Centralization Hare"

- New England Economic Review* (June/July 1998), 13–140; Robert Tannenwald, “Come the Devolution, Will States be Able to Respond?” *New England Economic Review* (June/July 1998), 53–73; Pietro Nivola, “Last Rights for States’ Rights?” Brookings Reform Watch bulletin (June 2000) <http://www.brookings.edu/comm/ReformWatch/rw01/rw1.pdf>
- 5 See, *inter alia*, Thomas Dye, *American Federalism: Competition Among Governments* (Lexington, MA: Lexington Books, 1990); Alan Altshuler, William Morrill, Harold Wolman, and Faith Mitchell (eds) *Governance and Opportunity in Metropolitan America* (Washington, DC: National Academy Press, 1999); Mark Schneider, *The Competitive City* (Pittsburgh: University of Pittsburgh Press, 1989); Daphne Kenyon and John Kincaid (eds) *Competition Among States and Local Governments* (Washington, DC: The Urban Institute Press, 1991); Daphne Kenyon, “Theories of Interjurisdictional Competition,” *New England Economic Review* (March/April 1997): 13–28; Wallace Oates and Robert Schwab, “Economic Competition Among Jurisdictions,” *Journal of Public Economics* 35 (April 1988): 333–54.
  - 6 This section is drawn from Michael A. Pagano, “Good Governance in Federal Polities: Issues for the 21<sup>st</sup> Century,” in Kousar J. Azam (ed.) *Federalism and Good Governance: Issues Across Cultures* (New Delhi: South Asian Publishers, 1998), pp. 11–22.
  - 7 Fiscal illusion as just described is similar to the government failure identified by David Weimer and Aidan Vining as “Problems inherent in decentralization.” A decentralized political system, such as American federalism, they argue, complicates “the implementation process” (*Policy Analysis* [Englewood Cliffs, NJ: Prentice-Hall, 1989] p. 122) because of the difficulty in assessing consequences of alternative policies, an argument we find contrary not only to Tiebout’s argument concerning mobile citizens but also to the generally well-known social and political benefits of decentralized federalist systems.
  - 8 For an outstanding contemporary study on comparative federalism, see Michael Burgess, *Comparative Federalism: Theory and Practice* (New York: Routledge, 2006). See also, Scott L. Greer (ed.) *Territory, Democracy and Justice: Regionalism and Federalism in Western Democracies* (Basingstoke: Palgrave Macmillan, 2006); John Kincaid and G. Alan Tarr (eds) *Constitutional Origins, Structure, and Change in Federal Countries* (Montreal: McGill-Queen’s University Press, 2005); Mikhail Filippov, Peter C. Ordeshook, and Olga Shvetsova, *Designing Federalism: A Theory of Self-Sustainable Federal Institutions* (Cambridge: Cambridge University Press, 2004); Edward L. Gibson (ed.) *Federalism and Democracy in Latin America* (Baltimore: Johns Hopkins University Press, 2004).
  - 9 Prof. Francesco Boccia proposed the conference title and secured funding from the Italian ministry of economics and finance, la scuola superiore dell’economia e delle finanze. On 13–15 November 2003, the conference, “Which Federalism?,” was convened in Savelletri (Brindisi), Italy at the Masseria San Domenico.

# **Part I**

## **Constitutional and Political Framework**

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# Overview and Introduction

*Celina Souza*

Democratic federal polities are governed by constitutions and the task of writing or changing constitutions and of interpreting and implementing their mandates are subjected to several factors. Constitution-makings or constitutional reforms are periods of political maneuvering and negotiations, when political agreements and disagreements come to the fore with greater visibility. This means that, when called to write or to rewrite their country's constitutions or to change, reinterpret, and implement constitutional mandates, politicians, officials, and the courts are faced with hard choices. Furthermore, constitutions are likely to produce ambiguities, which, in turn, call for political and juridical interpretations. When constitution-makers opt for federalism, i.e., for a territorial division of power based on the apparent paradox of preserving diversity (self-rule) as well as unity (shared rules), politics play an even broader role, including in the implementation of this scheme of power division.

The assumption that constitution-making, constitution reform, constitution reinterpretation, and the implementation of constitutional mandates imply hard choices and collective action decisions is broadly recognized by the literature. However, this same literature also argues that it is only rational that decision-makers would avoid hard choices. Why, then, have so many new constitutions been written, changed or reinterpreted in the last decades and why have many adopted or strengthened federalism or quasi-federalism? In several moments of the 20<sup>th</sup> century there were waves of constitution-making: at the end of World War I and II; in the transition to democratic regimes in Southern Europe and in Latin America; in the post-colonial countries, particularly in the African continent; in Eastern Europe after 1989; and in the aftermath of social and political changes, as in South Africa. Rewriting constitutions have not been restricted to countries undergoing regime changes. Since 1970, several developed and some long-time democratic countries such as Belgium, Canada, the Netherlands, Sweden, Spain, and Switzerland have adopted new constitutions. This wave of constitutional reform is also reaching the 21<sup>st</sup> century, when Italy, for example,



underwent important constitutional changes.<sup>1</sup> In many of these countries, federalism or quasi-federalism was adopted or strengthened.

Kincaid answers the question of why federalism has recently become an option for many constitution-makers or reformers: "federalism is one of the key elements of debates and discussions about democratization, decentralization, marketization, individual rights protection, and minority community guarantees" (2002: 6). Kincaid's answer shows that federalism has been currently associated with a new political, social, and economic agenda which emerged at the end of the 20<sup>th</sup> century. Despite normative assumptions that federalism might help to address solutions to the above listed issues, we know that the design of political institutions like federalism has both causes and consequences. By causes I mean the reasons why, in a collective action situation, political elites opt for some institutions, such as federalism, rather than for others, such as a unitary system. This question is mainly addressed by Filippo Sabetti's chapter. By consequences I mean the possible effects of different institutional choices in different settings. The issue of consequences is closer to the object of Susan Clarke's and Ann Bowman's chapters.

Most of the issues raised above have been the object of studies on federalism, although considerable research is still necessary, particularly in comparing these issues in different federal countries. The list of these issues shows that there is a new political, social, and economic agenda which has an impact on the constitutional and political frameworks of federal polities. Some of the contents of this new agenda have been directly or indirectly discussed by these papers: (a) the world-wide trend toward decentralization as a way to improve self-government and how it influences federal and unitary systems, addressed by Filippo Sabetti; (b) the relationship between new processes of governing (governance) and federalism, addressed by Susan Clarke, and (c) the role of geographical, economic, and cultural spaces in delimiting the reach of governments, addressed by Ann Bowman. I will return to this new agenda later.

The issues raised so far rely on the obvious assumption that discussing the causes and consequences of constitutional and political frameworks in federal polities require the view that institutions do have relevant and predictable effects on a polity and that they do influence decision-making and outcomes. This does not mean, as in some new institutionalists' assumptions, that institutions are a set of interconnected nodes at which action is blocked (Peters 1996: 213) but rather that institutions have causes and consequences, coupled with predictable risks and opportunities, although their outcomes are not always predictable.

The picture drawn above, in particular the focus on causes and consequences, coupled with the content of the three chapters provide the bases to raise a few broad questions to guide our discussion about constitutional and political frameworks in federal polities and to ask whether there are

new questions which students of federalism ought to add to federalism's traditional research agenda.

Sabetti's chapter illuminates our knowledge about how in the 19<sup>th</sup> century intellectual and political circles have discussed the federal option and how political elites in the US and in Canada turned to federalism when they crafted their constitutional and legal systems but how the same did not happen on the other side of the Atlantic. In doing so, Sabetti provides an important framework to discuss causes and consequences by mapping and analyzing the history of federalist political ideas and of political thoughts in two North-American countries and in Europe, particularly in Italy. In his own words, Sabetti took the problematics of democratic development in 19<sup>th</sup>-century Europe to develop his argument that "the knowledge of how to extend principles of self-governance to large populations and territories – that is, how to bring together, and allow to work separately and jointly micro- and macro-institutional arrangements – exist." At the very end of his chapter, Sabetti, following his own analysis but also some other scholars' claims warns us that the history of European political thought might influence the emergence of a "United Europe based on statist or parliamentary principles" (Siedentop 2000 *apud* Sabetti), consequently preventing European polity from experiencing the much-praised North-American federalist ideal of self-government. This is because, argues Sabetti, ideas matter and the idea that representative political institutions are enough "to grant the choice of liberties" minimizes the importance of federalism as the real ferment for a self-governing society.

Sabetti's conclusion provides the grounds for raising a couple of issues and to debate a possible new research agenda on federalism. Sabetti's work can inspire us to embark on a more lengthy discussion about the worldwide trend toward decentralization and the ideal of self-government which follows it, on the light of the differences between decentralization and federalism. A second issue inspired by Sabetti's chapter is the role of local governments in the theory of federalism. Sabetti's advocacy of federalism as the ferment for self-government might suggest that the local sphere would better suit the aspirations for a self-governing society. This calls for the debate about the theoretical role of local governments in federal countries and this call derives from the fact that theories of federalism are largely based on the US model, in which local governments are a creation of the states. Further developments in other countries, such as in Brazil, India, and Belgium, have given federalism a trilateral dimension by institutionalizing in their constitutions a three-tiered federation. Therefore, in a few countries the municipalities (or the communities as in Belgium) are not a creation of the states but rather they are members of the federation together with the states and they have been granted effective political autonomy and own resources by the federal constitution, as is the case of the Brazilian Constitution of 1988. The reality of some federal countries in

which there has been a political, a financial, and a constitutional upgrading of local governments granted by the constitution, and not by decentralized policies alone, might be claiming for innovation in federal theory. It might be also claiming for further discussions about the relationship between local governments, decentralization, self-government, and participatory decision-making mechanisms. Is governance, as discussed by Susan Clarke, a possible tool to link, theoretically and practically, these structures and processes?

Susan Clarke's chapter provides an analytical synthesis of the concept of governance, as well as a discussion of the concept *vis-à-vis* the theory of federalism. By doing so it brings our attention to certain issues not usually related to federalism, but generally more focused, as Clarke argues, on revenue and taxation systems and on service-delivery mechanisms. By using the governance concept Clarke shows that there is a new agenda for federalism studies. She also shows the causes and the consequences of the introduction of new mechanisms for addressing the dilemma of how to govern. Furthermore, her approach displays that answers to fundamental political questions about who governs and how and about who should govern and how is not completely addressed by constitutional principles alone.

Clarke's central concern is how to prevent governance (or government) failures and how to create incentives for cooperation. Although it is not possible to ignore the existence of governance structures because of the increasing interdependence between public and private actors brought about by, for instance, globalization. Clarke is cautious about its consequences, not for purely ideological reasons but more likely because governance, as much as other mechanisms designed to overcome the limits of representation, such as decentralization, civil society organization, participation, and the empowering of marginalized groups, still present several unanswered questions, making it an important priority for academics and practitioners.

The importance of governance to federalism is because, says Clarke, "the most important federalism issues in the 21<sup>st</sup> century will have to do with governance." Among the changes brought about by governance, Clarke stresses one: "whether traditional characterizations of leadership in federal systems are adequate." This is because, according to Clarke, "governments alone cannot redress the problems facing them; cooperation and coordination across jurisdictions and between the public and private sector is critical." This implies that, as Clarke argues, while the outcomes of governance efforts may be similar to those produced in the past, the processes are now different and new. Therefore, new processes brought about by new agendas are likely to produce different consequences for institutions like federalism.

The line of inquiry about cooperation has shown that for cooperation to flourish, a set of incentives are necessary. These incentives need not be pro-

vided only by hierarchical means. As Elinor Ostrom (1990) has shown, and as Clarke agrees, it is possible to build bottom-up institutional arrangements that enable people to cooperate; therefore cooperation through governance strategies need not necessarily be a top-down strategy. Although Ostrom acknowledges that much more work is necessary to develop a theory of collective action, the question that remains is whether governance can be applied as a valid concept for how to redress problems faced by contemporary governments unless it can be identified what makes public and private actors work cooperatively. Can we apply a governance framework properly without investigating at length, as Ostrom did, what kind of incentives are necessary for governance to occur? Furthermore, which are the consequences for federalism when governance strategies are at work, i.e., how is federalism affected by governance, in particular federalism's normative assumption that the system creates incentives for dispersed power?

The chapter by Ann Bowman, as much as the two other chapters, brings new insights to our debate. The chapter identifies and analyzes the shifting geographical boundaries of US constituent units, showing how economic, social, cultural, and political characteristics many times do not coincide with the legal boundaries within a federal country, in particular state boundaries. Bowman's main conclusion is that borders not only matter but also the manner in which space is subdivided to create places has a powerful impact on the way the political system operates. Several examples based on empirical evidence are cited by Bowman, showing that "borders exert significant influence on economic and sociological aspects of the human experience" (Timothy *apud* Bowman). Furthermore, Bowman adds, borders matter politically and their definitions reflect why they were determined the way they are (causes) and their consequences.

The results of such political decisions show that borders may fuel secessionist sentiments and secessionist movements, caused by a feeling that a given space has limited political influence in the state's decision-making process, therefore decreasing citizens' sense of belonging to the state. Of great interest to the federalism debate is Bowman's conclusion that local boundaries do not have the same effect as state boundaries because local jurisdictions may share the same territory.

The question we can ask is whether federalism is a response to accommodate secessionist sentiments and movements. From what we learn from Bowman, the answer has so far been yes for the US case. However, can we say the same about other countries? The breakdown of the former Yugoslavia points to a negative answer. Yet, by the same token, why has a unitary country like Italy been able to accommodate tensions and conflicts among its regions? These examples might suggest that we ought to debate issues about fiscal federalism but which have a greater political consequence for federalism: although elements of fiscal equalization are not

central to the political theory of federalism, how long can some federal countries sustain their unity when regional cleavages and social and economic inequalities are too high? This is particularly important in developing countries, such as Brazil and India. Furthermore, globalization and the opening up of the national economy tend to increase the differences between more and less developed states and regions. High regional inequality, if not addressed, prevent the citizens of a poorer region (or space) from what is guaranteed in Germany's Basic Law, i.e., uniform living standards. In many countries, high regional (or space) inequality is probably one of the most complex problems facing federalism. A crucial question is, how long will migration to other states, municipalities, and even to foreign countries be able to buffer the lack of provision of the basic needs for citizens of poorer spaces (Souza 2002)? However, although federalism alone cannot address this question and regional inequality is not limited to federal countries, high regional/state inequality has certainly severe political impacts. Addressing regional inequality should be on the same level of importance for federalism literature as much as its concern about religious, ethnic, and linguistic cleavages.

The chapters in this part provide important foundations and evidence about how to approach and analyze the constitutional and political causes and consequences of federalism. The contemporary wave of constitution-making and reform signals that federalism research is challenged again to bring constitutionalism back into the agenda. By doing so one might understand better the hard choices politicians and constitution interpreters are making to adjust political institutions created some centuries ago to new economic, social, and political agendas.

Although focusing on different issues, the chapters share a common goal: the analysis of the causes and consequences of federalism (or the lack of federalism) and the impact of other institutions, processes, and ideas on federalism. Underlining all the chapters seems to be the assumption that institutions are not neutral devices and that the crafting and recrafting of political institutions are bounded not only by a web of past events but also by new challenges which, in turn, open the way for new research agendas for academics and new challenges for practitioners. Although there are new questions and challenges to federalism brought about by the current era's new challenges, the old issue of power-sharing remains at the center of federalism's inquiry and practice.

## Notes

- 1 Lane (1997) labels this process as the fourth wave of constitutional reforms, drawing a parallel with Huntington's (1993) third wave of democratization.

# 2

## Types of Federalism: Achieving Self-Governing Capabilities in Societies with Federal Potentials

*Filippo Sabetti*

The chapter advances several arguments. First, it explores why people turn to federalist ideas in crafting or recrafting their constitutional and legal systems. This discussion sheds some light on why political systems form the way they do. Second, the chapter highlights the principal challenges people face. The main issue is not which federalism understood as design blueprint applies but rather what design criteria ought to apply. This does not mean that people in designing their own system cannot learn from existing federal systems. It just means that transplanting blueprints of institutions from one country to another, or presuming to construct political arrangements for others, usually does not work. Third, the successful application of federal principles of organization is not automatic but contingent on all sorts of existing conditions, including initial setting and political forces. What these are need to be carefully surveyed. Moving from one system of governance to another is seldom easy and requires a long-time span that may not always be available to people aspiring to be self-governing or to create a larger union. How to extend principles of self-government to large populations and territories – that is, how to bring together, and allow to work separately and jointly, micro- and macro-institutional arrangements – remains problematic. In fact, robust findings suggest that “effective and long-lasting constitutions are frequently negotiated at a micro-level rather than at the macro-level of an entire political system” (E. Ostrom 1989: 12). I hope to show that this is no argument for despair, but a call for work that remains to be done to achieve, in Larry Siedentop’s words, “democracy in Europe” (Siedentop 2000). The project of creating a federal system within individual European countries and the European Union represent some of the major challenges for federalism in this century.

The chapter uses the problematics of democratic development in 19<sup>th</sup>-century Europe to explore these issues. It highlights the need for a new science of politics that emerged throughout Europe in the 19<sup>th</sup> century. It then discusses why some of the best European minds turned their attention

to the theory and practice of North American federalism to justify and support the realization or transformation of their own system of government into a federalist or regionalist state. The chapter suggests why such attempts could not generate the desired results especially in the liberation and unification of Italy. At the same time, this lack of success paradoxically served to keep on the public agenda the attractiveness of the federalist principles of organization as alternative design principles until contemporary times. The chapter concludes with some implications for the prospects of democracy in Europe today. But first, in the way of context, we turn to the kind of federal systems that could be found in North America by the 1860s.

### **Alternative types of federal systems**

The political circumstances of the late 1780s was a critical juncture for the American union. The conditions of government under the Article of Confederation had led to frustration and dissatisfaction. A political stalemate existed; and there was little opportunity for resolving that stalemate within the constitutional decision rules of the Articles of Confederation. Somewhat similar political circumstances existed by the 1860s for the union of Lower (Quebec) and Upper (Ontario) Canada established in 1841. The Union was not working and people in other British North American territories were pressing for representative government. Just as the work of the Philadelphia Convention of 1787 was a new model to improve and perpetuate prior efforts to design the American Union, so the work of the Fathers of Confederation between 1864 and 1867, by extending the principles of representative government to a larger group of British North America provinces, was a new way to end the deadlocked union of Lower and Upper Canada. While Canada's founding debates did recognize the importance of the consent of the governed (e.g., Ajzenstat *et al.* 1999), the constitutional settlement that emerged between 1864–67 affirmed that the best form of government was the parliamentary system, thereby rejecting several of the fundamental constitutional principles upon which the American republic was founded and upon which rest the analysis of *The Federalist*.

Two different types of federal systems emerged in North America. They reveal the extent to which the institutional choices people make take place within particular political traditions and initial conditions that can give rise to critical differences in the way design principles of organization are understood, implemented and made operational. But federalism in each country was presumed to have greater capacity than unitarism to address, come to terms with and resolve collective-action problems, even when these appeared intractable. This argument is grounded in several empirical observations.

Highly federalized systems of government by their very polycentric nature are less likely to be overloaded with problematic situations; they are almost constantly in the process of moving toward new forms of federalism or adjusting to new expressions of self-governance and constitutional choice. Contrary to unitary systems, federalized systems offer greater advantages of diverse economies of scale applicable to both the production and provision of public goods and services; they also provide citizens both with greater voice in the conduct of public affairs and with a larger number of institutional remedies for grievances.

Federalism in the United States is more than its constitutional and institutional structures. The work of Daniel J. Elazar and colleagues associated with the journal of federalism *Publius* has been critical in drawing attention to “federal theology” as the covenantal basis on which the American federal arrangements rest (Elazar and Kincaid 2000).<sup>1</sup> As developed in America for some 165 years before 1787, covenant-related ideas are associated with the development of American federalism in at least three ways (Allen 2005).

First, covenant expressed a desire of many colonists to achieve union with liberty and diversity, namely to create effective governing entities while still allowing constituent members to express independent wills. John Winthrop, the first governor of Massachusetts, referred to this communitarian liberty as “federal liberty.” Thus covenant devices were used to form not only marriages and congregations but also towns and states, and sometimes amicable relations with Indians. Second, covenant ideas led to the federative principles in both religion and politics – in “harmonizing earth with heaven” (Allen 2005). Many church congregations federated voluntarily to form larger denominational bodies. Similarly, towns often federated into larger entities. The state of Rhode Island, for example, began as a federation of towns. Third, covenant-making was a practical experience that contributed to the American habit of constitution-making. American colonists were already covenanting and compacting into body politics before such European theorists as Hobbes, Locke, and Rousseau articulated their compactual political teachings. Social compacts were real in America, not theoretical constructs or myths as they were for most of Europe.

What was the nature of the Confederation settlement of 1867? Perhaps no other single set of questions in Canadian political history has evoked as much divisions and controversy as this question (e.g., Ajzenstat and Smith 1995). Francophone analysts, until the 1960s, attempted to show that Confederation was indeed the effectuation of some form of compact between the English and the French. This view was, however, dismissed by most Anglophone scholars, either as a sheer invention or as a fruitless enterprise. There are several reasons that make it difficult to show the conscious use of covenant ideas and concepts in the making of Confederation (Sabetti 2000a).



First, covenantal terms had become loaded with negative or pejorative connotations in English Canada. By the 1830s both Upper Canada (Ontario) and Lower Canada (Quebec) were under the tight control of a combination of the leaders of government, business and the Church of England. In Upper Canada this oligarchy became known disparagingly as “the Family Compact.” It was with such pejorative connotations that the term compact gained popular and widespread currency in British North America. In part for these reasons, providential or covenant theology could not furnish the moral and metaphysical grounds for collective action among English, Protestant Canadians in the early Victorian era (see Wise 1980). In turn, the term covenant was popularized by those who rebelled against the Family Compact and worked for the establishment of democratic institutions a la United States. The 1837 rebellion against such ruling cliques was put down and the idea of covenanting federalism *à la* United States became associated with disloyalty and treason. This chain of events thus strengthened critical differences between the constitutional arrangements of the American Union and the making of a United Canada.

Second, the establishment of Confederation in 1867 was not a sharp break with the history of British North America since the conquest of New France in 1763. It is true that provincial delegations met in Quebec City and Charlestown to discuss the terms of union of British North America. Ormsby suggests, that “(t)he survival of French Canada, despite the deliberate attempt to overwhelm it in a union of the two Canadas, demanded the emergence of a federal concept” (Ormsby 1969: 51, 120–1). Without the Francophone community, the union would have proceeded along centralized lines. The first prime minister of Canada, John A. Macdonald, favored “one government and one parliament legislating for the whole of these peoples ... the cheapest, the most vigorous, and the strongest system of government we could (have) adopt(ed)” (Macdonald 1865, quoted in Waite 1963: 40). Confederation took place within the British empire and the North American Loyalist tradition to the Crown. The very details of the union were left to the imperial authorities with the counsel and assistance of representatives of the several provinces. Canada was to be one Dominion under the Crown of the United Kingdom of Great Britain and Ireland, “with a Constitution similar in Principle to that of the United Kingdom” (cited in Rogers 1931: 219).

Third, “a constitution similar in Principle to that of the United Kingdom” meant, in effect, parliamentary omni-competence and majoritarian rule at the federal and provincial level of government – what in modern parlance is referred to as responsible party government. The omni-competence of provincial legislatures was constrained by the federal government through its power of disallowance and reservation over provincial acts and laws. Majoritarian rule or English dominance was constrained somewhat at the federal level by the recognition of the minority French language as an

official language of government. In the province of Quebec, the language of the French majority and the language of the British minority were recognized as the two official languages of government and public instruction. The use of French received no written guarantee outside of Quebec. Just as the emergence of the federal concept assured the survival of French Canada, so the reiteration of parliamentary government as the best form of government in 1867 assured the continuation of the executive centered system of government of colonial times (Sproule-Jones 1984).

Thus, the terms of the 1867 Canadian constitutional settlement combined federal and unitary principles of organization while the settlement itself was created by a statute of the imperial parliament. It may be useful to summarize critical differences between the American and Canadian federal and legal systems:

1. Unlike the United States, Canada was not the creation of a covenant, or a social compact embodied in a Declaration of Independence and written constitution. As a result, "whereas American society rests on assent constantly renewed, Canadian society [at least until the patriation of the constitution in 1982] depend[ed] from the historical and objective reality of law personified by the monarch and modified as need arises by the Crown in Parliament" (Morton 1961: 85–6).
2. There is no separation of legislative and executive powers at the provincial and federal levels of Canadian federalism.
3. The two types of federal systems sharply differed on a most crucial defining characteristic of federalism: the distribution of the powers of government between the national and the state/provincial authorities. Section 8 of the American constitution specified the powers of Congress and the Tenth Amendment of 1791 enacted that "the powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people". This was rejected by the Fathers of Confederation. Not only did the British North America Act confer what were then regarded as the most important classes of power on the Dominion, but it also went on to provide that the national authorities might by unilateral action involve themselves in the provinces' exercise of their exclusive legislative powers.
4. Unlike the American, the Canadian Constitution, as it emerged from the negotiations of 1864–67, was not submitted to ratification by popular conventions. The British North America Act of 1867 was an instrument of governments alone, which neither embodied any hint of democracy nor showed any sympathy for the principle of popular sovereignty.
5. Whereas government in American federalism is *limited* government, parliamentary government in Canadian federalism is *omni-competent* and unlimited [at least until 1982].

6. Unlike the American experiment, the Canadian constitutional settlement contained no formula or machinery for its own amendment. The standard explanation is that by the 1860s the British parliament “still regarded itself as the supreme constituent power in the British empire, and it would not lightly have been persuaded to grant a wholly Canadian procedure of amendment” (Mallory 1977: 24). The absence of an amending procedure was no problem as long as Confederation worked as its creators intended.
7. Notwithstanding the differences in the federal principles invented by the Americans, the new Canadian Dominion emerged in important dimensions as a federal union with two sets of governmental authorities, each drawing its powers from a constitutional document which neither could at its own discretion amend. The most innovative dimension of the Confederation settlement was the combination of federalism, albeit federalism in a compromised form, with the Westminster model of parliamentary responsible government. As has been noted, “the Canadian constitution at the time of the creation presented to the world of political science a novel combination of constitutional principles – a monarchical federation based upon legislative supremacy under a single external sovereign” (Scott 1977: 35).
8. The different institutional designs of the American and Canadian systems of government gave rise over time to quite different practices which in turn have led to different if radical transformations or challenges to American and Canadian contemporary politics. Bluntly put, these transformations are as follows: if centralization has taken place in Washington, centralization in Canada has occurred in the provincial capitals.
9. Since the establishment of the Charter of Human Rights and Freedom in the Canadian constitution in 1982, the judiciary in Canada has come increasingly to occupy a central role in policy-making, much like that exercised by the American Supreme Court. In this sense, there is some convergence of the two federal and legal systems.
10. In part because of point no. 9, the Canadian system has extended rights of self-government and immunity from taxation as well as many other economic benefits to aboriginal people who appropriated for themselves the claims of sovereign nations. This sovereignty allows to claim specific inherent rights to the point of being equal to provincial and federal governments (“nation-to-nation” basis) in (re)negotiating the terms and conditions of Canadian federalism (see Flanagan 2000).

At the time of the American Civil War and Canadian Confederation, the problematics of revolution, reform and change were reverberating throughout Europe as well.

## The European state challenged

The reconstruction of Europe that followed the Congress of Vienna in 1815 restored absolutist and dynastic principles to their former pre-eminence in the practice of rule. The Restoration thwarted but could not entirely stunt the growing aspirations of people to rule themselves that had been given impetus by the American and the French revolutions, the rise of nationalism, the spread of free trade among nations, as well as by the democratic direction of long-term social change. As a result, no sooner had the sovereignty of kings been reasserted than it ran up against the claim of popular sovereignty. As Mazzini put it in an essay on "Thoughts Upon Democracy in Europe" for a British journal in 1847: "The democratic tendency of our times, the upward movement of the popular classes, who desire to have their share in political life – hitherto a life of privilege – is henceforth no Utopian dream, no doubtful anticipation. It is a fact, a great European fact; which occupies every mind, influences the proceedings of governments, defies all opposition" (Mazzini [1847] 1891: 4, 98).

Liberalism, with its emphasis on macro-constitutionalism, representative government, the rule of law and private property, was becoming reconciled with nationalist aspirations. But the search for an appropriate constitutional knowledge grounded in human liberation offered a critical challenge concerning what useful knowledge ought to apply for rethinking the conditions of life associated with human artisanship and civilizing progress and whether the world of action should have reference less to education and more to plotting and waging wars of liberation with the alluring rhetoric of statecraft. Unlike Germany, no clash occurred in Italy between the liberal creed and the struggle for national independence (Woolf 1979: 359–60). But the fundamental challenge faced by Italian liberals and patriots still remained a choice between "seeing like a state" (Scott 1998) or "seeing like citizens" (V. Ostrom 2001).

The chief problem in 19<sup>th</sup>-century Europe was that it was unclear what constituted democratic governance. According to R.R. Palmer (1959: 1, 18), "it was in Italy that the word 'democracy', in a favourable sense, was most commonly used in the years from 1796 and 1799". But common usage was not enough to fix its meaning. Italian democrats, as elsewhere in Europe, tended to confuse democracy either with a unitary state or with the universality of citizenship (Palmer 1964: 2, 302–5), with the result that Mazzini, in his own time, could still write, "(t)he union of the democratic principle with representative government is an entirely modern fact, which throws out of court all precedents that might be appealed to; they have nothing in common but the *word* in common; the *thing* is radically different" (Mazzini [1847] 1891: 4, 102; italics in the original). What this "thing" stood for was not entirely clear. This appeared so also to Cavour who, in a review essay noted, "that democracy is a very elastic word that can be equally applied to

different systems and that it corresponds to particular meanings when the word is uttered by Gioberti or Mazzini, by Louis Blanc or by an American follower of Washington or Jefferson" (Cavour [1850] 1971: 171–2).

One issue, however, seemed clear enough: neither the liberal nor the democratic movement, or some combination of the two, offered a satisfactory resolution to the paradox of revolution that had emerged with the French Revolution and was reaffirmed in the 1820 and 1848 revolts. In the aftermath of successive failed revolts, and in spite of Mazzini's revolutionary fervour, one fact had become evident in Vienna as in other European capitals: just as national armies could not indefinitely shore up absolutist rule, so popular uprisings could not succeed without falling back into new forms of tyranny and subjection. For these reasons, Tocqueville was not exaggerating when in 1835 he noted, "the great problem of our time is the organization and establishment of democracy in Christian lands. The Americans have certainly not solved this problem, but they have furnished useful lessons to those who wish to solve it" (Tocqueville [1835] 1969: 1, 311).

### **What Europe could learn from America?**

The problematics of revolution, reform and change reverberating throughout Europe gripped the imagination of many intellectuals and challenged them to offer solutions. To those schooled in the statecraft of despotism – enlightened or not – the growing aspirations of different communities of people to rule themselves represented a paradigmatic challenge of major proportions. At the same time, these growing aspirations could easily go astray if people were unacquainted with, or did not understand how to reap the fruits of, the long-term democratic tendencies taking place in society. Witness what had happened to the 1812 constitution of Sicily and to the liberal movement in Spain after 1820. The former had been doomed to failure, not only by the hostile international climate, but also by the very haste with which it had been introduced; the latter by its excessive rationalism or Jacobinism.

Self-rule required new ways of thinking about old issues, as well as new ways of governance and a radical reordering of political ideas and practices that could not be easily achieved in a short time span. And here critical issues emerged that could be ignored only at great peril: where could people turn for the likely sources of such ideas? What prior conditions were necessary for new habits of heart and mind to flourish? Could the paradox of revolt be overcome? Could constitutional government be obtained only with the consent of the monarch? If, in the 18<sup>th</sup> century philosophy had been called in to the aid of the Government, now philosophy was called upon to aid the people to govern themselves and even to change the world.

### Tocqueville's response

An important response came from France, couched not in the form of a philosophical treatise or manifesto, but in the form of an empirical investigation by a young aristocrat and magistrate, Alexis de Tocqueville. France was important because of its experience in dealing with the meaning of the long-term trend toward equality, and the puzzle that the trend posed for liberty and innovative potential in 19<sup>th</sup>-century Europe. Rather than study France, however, Tocqueville's response was to study those trends in the United States. For, as he explained: "It was there that civilized man was destined to build society on new foundations, and for the first time applying theories till then unknown or deemed unworkable, to present the world with a spectacle for which past history had not prepared it" (Tocqueville [1835] 1969: 1, 30). What could Americans teach Europeans?

To paraphrase the Declaration of Independence, the *Federalist Papers*, and Tocqueville's own research, the American experience could teach several things: (1) that human beings are not forever destined to depend for their political constitutions on accident and force and can indeed exercise reflection and choice in creating systems of government; (2) that such choices draw upon certain conceptions articulated as principles that are, in turn, used to specify structures or forms so that when acted upon, these conceptions and structures have effects that bear significantly upon safety and happiness of a people and other fundamental values important in their lives; (3) that it was possible to have local autonomy, and to fashion self-governing units, without reference to unitary conceptions of rule or to central authority; (4) that rulers can also be ruled through a system of overlapping jurisdiction, checks and balances, juridical defense and individual sovereignty; (5) that possibilities other than central government monopoly existed for solving public-sector problems, and (6) that, contrary to prevailing fears in Europe, equality of conditions was not incompatible with the maintenance of liberal practices like representative institutions, individual liberties, local autonomy, private property, and even religion.

The American federalist experiment had radical implications for understanding the meaning of self-governance beyond particular forms of government, for building the commensurate institutional structures and, equally important, for conceptualizing modes of analysis appropriate to a democratic age. A science of the state, government or legislation could not encompass what is required for the development of self-governing units. Instead, a science of association was called for as the appropriate theoretical foundation for a self-governing society. Tocqueville's new science of politics also drew attention to the importance of long-term cultural development and suggested particular relationships between democracy and civilization. Tocqueville's paradigmatic shift stood in sharp contrast to the tradition of the French *philosophes*, which had given scant consideration to the history of human development, and to the prevailing efforts at reform

and change in France that, far from bringing out the advantages of democracy, reiterated some of its vices by extending the prerogatives of government and increasingly preempting individual autonomy (cf. Craiutu 1999 and 2001). Tocqueville's paradigmatic shift contrasted equally with dominant modes of constitutional problem solving and statecraft in Europe.

One influential tendency among European intellectuals was to dismiss altogether the theoretical and practical significance of America's "great political experiment." Just about the time that Tocqueville and Beaumont were setting out on their journey to North America, Hegel was lecturing to students at the University of Berlin that Europeans had nothing to learn from America politically, for it was still a developing country, lacking a fully developed central authority or state. Hegel told his students that "It (was) ... not yet possible to draw any lessons from America as regards republican constitutions" (Hegel [1830] 1975: 170). For Hegel, individuals achieve full or true freedom only as members of the (unitary) state. In his critical commentary on Hegel, Marx advanced a conception of democracy consistent with Tocqueville's conceptualization of society governing itself (Marx [1843] 1970: 29–30). Whereas Tocqueville held the view that popular democracy, as a mass phenomenon, required all the more a new science of politics to minimize new sorts of despotism, Marx held the view that once democracy was in place a science of politics would no longer be needed, because the difference between reality and appearance would, just like the state, wither away (Marx [1843] 1970: 31).

British analysts, and especially John Stuart Mill, showed, in turn, more appreciation for Tocqueville's work. But they generally did little to amplify or extend his analysis. This does not mean that British thinkers did not have aspirations to develop a new science of politics. In fact, such aspirations led to a diversity of intellectual endeavors in the course of the 19<sup>th</sup> century. But these endeavors did not go beyond reiterating the principle of representative government as "the grand discovery of *modern times* (James Mill, quoted in Collini *et al.* 1983: 102, emphasis added). The general tendency among British analysts – often described as the "lights of liberalism" (Harvie 1976) – was to treat the British parliamentary system as the exemplar of representative government in action, and to equate the meaning of liberal democracy with forms of government, national elections and majority rule.

For these reasons, colored by the expectations of an imminent collapse of the papacy and even disappearance of the Catholic church, "the lights of liberalism" as late as the generation of James Bryce, who in his youth had unsuccessfully sought to join Garibaldi's irregular army in the liberation of Southern Italy, hailed the creation of the Italian state as one of the most notable achievements of the 19<sup>th</sup> century. However, by privileging this particular process of unification, or by focusing too much on Mazzini, they missed or ignored a movement of ideas connected with the struggle for



Italian liberation and unification, whose preoccupation about the problematics of revolution, reform and change in Italian society, whose understanding of the meaning of democracy and whose attempt to fashion a new science of politics paralleled Tocqueville's concerns and differed sharply from prevailing British and German ideas. It is among these currents that it is possible to find serious discussions about what lessons American democracy could furnish Europe.

### Cattaneo's response

Carlo Cattaneo (1801–69) was widely regarded by contemporaries as a gifted public intellectual and a leading figure in the republican, federalist, democratic current of the Italian Risorgimento. Following the collapse of the 1848 revolts, he took refuge and settled in Switzerland, where he is now regarded as one of Canton Ticino's outstanding 19<sup>th</sup>-century figures. Cattaneo was four years older than the other great republican of the Risorgimento, Giuseppe Mazzini, whose national and international reputation completely overshadowed his own. But it is Cattaneo who has been hailed variously, since his death, as "Italy's greatest political economist and philosopher," (White Mario 1875), "the most profound and versatile intellectual of all the Italian Risorgimento," (Woolf 1979: 343), "the only self-conscious theorist of liberalism in nineteenth-century Italy," comparable in many ways to John Stuart Mill (Bobbio 1971: 183, 209), "a committed comparatist" (Cafagna 2001: 11), and even "the last of the great Encyclopedists, the universal scholar" (Carbone 1956: 56). When every possible allowance is made for exaggeration, there is something to these characterizations. The chief reason is that, to borrow from the description of John Stuart Mill by John Gray (2000: 13), Cattaneo's ideas and framework of analysis – like Mill's – were not shaped by a narrow, intra-academic agenda, but by the great social, economic and political transformations of his time.

Carlo Cattaneo's interest in the American political experiment and what it had to offer to Europeans developed independent of Tocqueville's. Just around the time when Hegel suggested that there was not much to learn from America, and when Tocqueville was still composing the first volume of *Democracy in America*, Cattaneo used the Nullification Controversy between South Carolina and President Jackson to reflect on the American experience – in what was also his first-signed article for a leading Milanese journal (Cattaneo [1833] 1956, *Scritti Economici*, henceforth *SE*, 1, 11–55). On the strength of the American and British documentation available in the Milan reading rooms and, perhaps, through consular services, Cattaneo brought to life for his readers the complexities of the Nullification Controversy, the problem-solving capabilities of a federal union and, more importantly, the principle "that a nation can govern itself by itself" (Cattaneo [1833] 1956 *SE*, 1, 30). At the same time, Cattaneo viewed slavery in and beyond South Carolina, with deep foreboding for both the



oppressed and the oppressors for “the laws of humanity are not offended without impunity” (Cattaneo [1833] 1956 SE, 1, 27). For this reason, he was prepared to grant human rights precedence over and above the anti-tariff and free trade stand taken by South Carolina.

Like Tocqueville, Cattaneo drew attention to the importance of religion – from a human point of view as opposed to what constitutes true faith – for the working of democratic institutions. The Bible is perhaps the most cited work in all of Cattaneo’s writings. His liberalism, not unlike that of French liberals, drew strength from the moral equality found in Christianity – a point he often loved to make in his more polemical, anticlerical, writings. Extending his reflections beyond America and Europe, Cattaneo called for “a public science” to understand how culture, order and tempered liberty [enlightened self-interest] can be brought together to offer better life prospects to peoples in Europe and other parts of the world (Cattaneo [1833] 1956 SE, 1, 23).

To be sure, Cattaneo was not the first Italian thinker to look to the United States as a model for a functioning republic. Already in the 1780s a young Lombard aristocrat, Luigi Castiglioni, had spent two years traveling in all 13 states, curious “to see the political birth of a republic composed of diverse nationalities, scattered over vast provinces far removed from one another and varied in climate and products” (1790, quoted in Grab 1989: 41). Admiration for the United States extended to the intellectual and ruling class of the kingdom of Naples as well. Many Italian patriots during the revolutionary years of 1796–99 felt a strong affinity to the Americans for, in the words of a Venetian translator of both the Pennsylvania constitution of 1776 and one of Benjamin Franklin’s books, they “were the first to philosophise on the true spirit and advantages of liberty” (quoted in Palmer 1964: 2, 299). Cattaneo himself appears to have studied intensely some of the 29 volumes on the history of North and South America, published in the early 1820 by Giuseppe Compagnoni (Cattaneo [n.d.] 1981, *Scritti Letterari*, henceforth *SL*, 2: 63n1).

Nor was Cattaneo the only Italian of his generation to be touched by Tocqueville’s work. Many other educated Italians had been equally impressed. The philosopher-priest Antonio Rosmini, for example, incorporated at some length Tocqueville’s ideas in his two-volume work on the philosophy of politics (Rosmini [1837] 1994: 2, 54, 59, 101, 184–6, 231–2, 323–5, 338, 396–8, 410, 417–18, 428–30). Perhaps the most prominent was Camillo Benso di Cavour, who personally knew Tocqueville whom he had met in Paris and London (with Nassau Senior), and admired his work for, in Cavour’s own words, it “throws more light than any other on the political questions of the future” (Cavour, cited in Jardin 1988: 228; see also Brogan 1992: 132n16). What is distinctive about Cattaneo is that, perhaps more than any other Italian publicist of his time, he looked to federal, non-unitary principles of organization as providing a solution to the problem of

how to reconcile liberty with independence, national unification with local autonomy – in brief, to effect self-rule with shared rule without hierarchic coordination.

Like Tocqueville, Cattaneo sought to help people of his generation to orient themselves toward the challenge implied by the progress of civilization and the aspirations of people to govern themselves. Both looked to the American federal experiment to argue that it was possible for a democratic society not to succumb to centralization. Both, in fact, were interested in overturning the entrenched European view of the state. It is evident that their individual projects were animated by a common vision of what constituted political order and by a strong interest in connecting political theory to political practice. The circumstances of their lives, including the specificities of their particular political problems, led them to pursue their respective inquiries in different ways.

Whereas Tocqueville used the American experience to present an alternative vision to that offered by the *philosophes* and the French statist experience, Cattaneo suggested that the alternative vision provided by American model of rule was consistent with the basic features of Italian and European ways of life and with what was universal, even if hidden from view, in the human condition. Cattaneo shared Tocqueville's concern about the danger of democratic despotism and the long-term viability of democratic prospects, but Cattaneo was still primarily preoccupied with the development and affirmation of liberty itself. For this reason, Cattaneo sought in a more self-conscious way to think through the problem of articulating the conditions under which the capacities for individual freedom and for self-governing systems can be developed and sustained while pressing for liberation from foreign rule. If in writing on democracy in the United States, Tocqueville sought to overturn the established French idea of the state, Cattaneo in his work sought answers to the fundamental problem facing Italians in Restoration Europe: how can national liberation and independence be achieved without destroying local institutions of self-rule – that is, without following the model history of European nation-states and without repeating the paradox of revolution experienced in France. Cattaneo seldom forgot the lesson he had learned from the Enlightenment: local autonomy, local patriotism and even self-interest could be compatible with, and made to work for, national unification under appropriate institutional arrangements.

Cattaneo drew inspiration and support for his political program from developments taking place in Lombardy-Venetia before 1848. There, under Austrian rule, a veritable agricultural, industrial, commercial and educational revival was taking place that had all the characteristics of a Risorgimento. In his now classic work on economics and liberalism in Lombardy between 1814 and 1848, Kent R. Greenfield successfully

captured the course of action that had the potential of achieving through reflection and choice the combined goal of independence and liberty:

It is clear that in the inner circle of publicists who ventilated the public interests of Italy between 1815 and 1848 there was a common idea that even when cooperating with Austria they were working towards ends that were beyond the reach of Austrian policy, and also a common conviction that they were in conspiracy with the course of events, with the march of the "century"; in other words, that they had found a method of action which compelled even the national adversary to cooperate with them, in so far as that power was alert to its material interests. This was their "conspiracy in open daylight" (Greenfield [1934] 1965: 286–7).

If such a conspiracy in broad daylight continued, unhindered to other parts of the peninsula, the time would come when it would be extremely difficult for any absolutist government or army of occupation to defeat it.

Events connected with the revolts of 1848 and their aftermaths reduced the prospects of this strategy, as Piedmont became the only parliamentary, constitutional monarchy, with a standing army, capable of taking the lead on the diplomatic front while inspiring liberals throughout the peninsula to favor unification under its banners. After 1849, from his refuge in Switzerland, Cattaneo focused most of his attention and correspondence, and used all his power of persuasion and prestige, in trying to convince republican radicals like Giuseppe Ferrari and republican revolutionaries like Giuseppe Mazzini not to engage in secret conspiracies and revolutionary activities, as they would in the end skew the outcome in favor of the Savoy monarchy.

Cattaneo's main preoccupation was that, in such a situation, it was relatively easy to mistake the temporal process of doing something for all that there was to the movement for national liberation and independence. He feared that the rush to action – with the inevitable reaction – would take precedence over learning and reflecting about what ideas to articulate as principles of self-governance. A widespread shared understanding of what liberty and self-governance meant was essential for a proper articulation of ideas as principles of governance. Without such an epistemic base, liberals of all sorts as well as republican revolutionaries would be tempted to mistake – and even engage in – struggles for sovereignty and power as struggles for freedom, as if what type of political order replaced the old made no difference in terms of what it means to practice the art of free citizenship. National independence cannot be achieved at the expense of liberty. This, Cattaneo thought, would be a disaster of major proportions. Hardly had a few months passed after his reflections reached the finality of print, that events in France confirmed the validity of his preoccupation.

On 2 December 1851 Napoleon Bonaparte staged a coup d'état in France and eventually assumed the title of emperor as Napoleon III. Giuseppe Ferrari, a friend of Cattaneo who identified himself with the radical-socialist factions in French politics and had a strong sympathy for the French revolutionary tradition, welcomed and supported the Bonapartist coup. He defended his position by insisting that all that the radical-socialists and democrats had lost was "our inadequate resources, our errors, misconceptions, and illusions; we faced a thick jungle that had to be cleared with a hatchet; should we bewail its sudden destruction by lightning?" (quoted in Lovett 1979: 85–6). In the words of his biographer, Ferrari cast Louis Napoleon "in the role of an avenging angel whose flaming sword was dispelling the fog that had been generated in France by the sudden birth of the democratic republic and by its equally rapid demise" (Lovett 1979: 86). From Cattaneo's vantage point, however, Ferrari's parabola epitomized what was wrong with those who put action ahead of the growth of democratic ideas and practices of freedom in society and the utility of institutional forms for the practice of self-government. Cattaneo criticized Ferrari for the same reasons that Tocqueville criticized the radical-socialist faction to which Ferrari belonged (Lovett 1979: 85–7). Unlike Tocqueville, however, Cattaneo did not directly engage his old friend.

In April 1852, in a letter to an Italian political refugee long involved in clandestine activities in France, Cattaneo did not mince words in what he saw as a critical problem for well-intentioned radicals: "You have a false doctrine and want to achieve liberty through a path that leads to dictatorship and empire, which is but dictatorship under another name; it is a social revolution without liberty." Cattaneo proceeded to remind him that "liberty is republic and republic is plurality, that is to say federation" (Cattaneo [1852] 1952a, *Epistolario di Carlo Cattaneo*, henceforth *EP*, 2, 157). He equally sought to persuade a revolutionary friend, Carlo Pisacane (Cattaneo [1852] 1952b) – unsuccessfully, it turned out, as Pisacane died heroically in an uprising with little or no prospect of success – that people like Ferrari were following a false doctrine because "the French revolution did not know how to extricate itself from centuries old tradition and faith in the omnipotence of rulers. The king's representatives gave way to the nation's representatives but the fervour engendered by discipline made them abandon liberty. The people had the land but not the commune" (Cattaneo [1864] 1965, *Scritti Politici*, henceforth *SP*, 4, 419). France is indeed the country that popularized revolution, yet it is the European country where it is least possible to make one, if by revolution we mean a profound overthrow and renewal of interests and not just a superficial change of administrative rituals (Cattaneo [1842] 1957, *Scritti Storici e Geografici*, henceforth *SSG*, 1, 285). The problems of reforming, or decentering, the state in France posed an enormous challenge that could not be overcome by successive generations of people there, including Ferrari's

well-intentioned revolutionary bourgeoisie. As Cattaneo put it, “the principle of ministerial omnipotence and omniscience” remained as a chief stumbling block to real change (Cattaneo [1842] 1957 SSG, 1, 285). This was the paradox of revolution that Toqueville was to highlight so well in his later work on the old regime and the revolution.

The problem of properly understanding the paradigmatic challenge of liberal democracy, of achieving both independence and liberty, was not just confined to France, to radical socialists like Ferrari, and liberal statesman like Cavour. It extended to Italian republican revolutionaries as well. Writing to Mazzini in September 1850 what is generally regarded the letter that marked the end of their collaboration and the beginning of a disagreement that changed into hostility, Cattaneo tried at some length to convince him – in a language that at times Mazzini must have assuredly found upsetting – that “the small undertakings are inefficacious if the people does not rise en masse; and they are superfluous if the people truly rises. The challenge is how to make it rise!” True to his evolutionary orientation and theoretical perspective and given his experience with the conspiracy in broad daylight in Austrian Lombardy, Cattaneo went on, unsuccessfully, to urge Mazzini to spend all his efforts to affect a change in the people’s heart and mind (Cattaneo [1850] 1952 EP 2, 45–6). The tendency to downplay the place of ideas and shared understanding in the world of action and even in the constitution of a political order appropriate to human liberation was not, however, confined to *engagé* intellectuals like Ferrari, Pisacane and Mazzini. As Cattaneo discovered in 1860, when Garibaldi called him to Naples to act in a consultative capacity, it applied to sincere patriots as well. In the end, Garibaldi mistook Cattaneo’s suggestions for a Neapolitan constituent assembly as a step in the creation of a political structure opposed to Italian unification; and Garibaldi was not at all displeased when Cattaneo respectfully withdrew from his entourage and returned to his Swiss village.

News of the American Civil War must have added to Cattaneo’s disappointment as the American civil war appeared to discredit the extension of federal principles to Italy and Europe – just as it did in the creation of the Canadian Confederation in 1867 (Sabetti 2000a). Even the creation of the 1868 federal republic in Spain must not have been a source of optimism for Cattaneo as the republic contradicted an important premise in his mode of analysis: the Spanish federal republic had not emerged from below; its constitution was imposed in haste from the top down, without much reflection about Spain’s own regionalist tradition and experience.

What, then, sustained Cattaneo’s positivity about the federal principle of organization that under-girded American democracy? On what did Cattaneo ground his optimistic prognosis for an eventual public acceptability of federalism both as theory of liberty-in-action and as practice of self-governance for Italy, Europe and other parts of the world? Let us briefly see.

*Local Foundations of Self-governance.*<sup>2</sup> Much of Cattaneo's published work since the 1830s is devoted to elucidating the local foundations of self-governance. Just as Tocqueville began his analysis of democracy in America with the townships, so Cattaneo insisted that federalism as a constitutional and institutional framework for a self-governing society must start with the commune as the fundamental unit in the science and art of associating together. Consider, he was fond of telling his readers, the extension of the science of association to all sorts of activities had given rise to enterprises of various shape to transform the United States into a country beyond expectations (Cattaneo [1864] 1965 *SP*, 4, 435). This is not the only place where Cattaneo echoed Tocqueville's emphasis on the spirit of association.

Tracing why and how Cattaneo used this particular point of departure in his analysis gives added currency to the American federal principles as his point of reference in two ways: it offers an understanding of Italy as physically and historically a federal country and a mode of reasoning about the art and science of association that remains applicable beyond the Italy of his time.

Like Tocqueville, Cattaneo viewed the commune as a natural and spontaneous congregations of people that can be found anywhere, albeit under different names. Communal institutions are "the fundamental plant" of any national public service system (Cattaneo [1864] 1965 *SP*, 4, 436). At the same time, communal institutions can be organized so as to foreclose the possibility of local residents acting in concert on matters of the commonweal. Such is clearly the case, Cattaneo commented, when communal government is the lowest chain in a bureaucratic system of public administration, or when the only inherent right of communal institutions is that of obedience or tutelage to a superior authority. In such instances, the commune ceases to be a communal society, a joint undertaking for better services and of better individuals. Moreover, bureaucratic administration does little to foster a desirable way of life and civic virtues among citizens. The surface solidity of bureaucratic administration is misleading, Cattaneo reasoned, for it is inevitable that "those who sow servility usually reap betrayal" (Cattaneo [1864] 1965 *SP*, 4, 420).

For Cattaneo, then, the central theoretical and practical question is not, is there local government? Local government can be found anywhere under all sorts of regimes. Rather, the central issue asks, is local government constituted to facilitate individual and collective efforts on behalf of common interests shared by local residents?

The worth of self-governing units goes beyond local matters. Echoing Tocqueville's description of American townships, Cattaneo noted that "the communes are the nation; they are the nation in the most important nursery school of its liberty" (Cattaneo [1864] 1965 *SP*, 4, 422). Why this is so? Because the skills and knowledge required for self-governance, like the art of harmonizing one's individual interest with that of others, can best be

learned in the practice of everyday life. Self-government cannot be successfully achieved through force or handed down from above. “Only too well is this demonstrated by the examples of France and Spain where liberty won by blood constantly eludes people because of the overwhelming power accumulated into the hands of government” (Cattaneo, cited in Carbone 1956: 71).

Cattaneo was not unmindful of the French contribution to civilization. He observed that “when the American people declared their independence, and the French proclaimed the Declaration of the Rights of Man, they both gave people everywhere lessons in philosophy,” (Cattaneo [1860] 1960, *Scritti Filosofici*, henceforth *F*, 1, 371) though the French Revolution left practically unaltered the centralized system of government (Cattaneo [1864] 1965 *SP*, 4, 419). For such a system of government, no matter what it calls itself – kingdom or republic – will not foster a theory of liberty in action (Cattaneo [1848] 1965 *SP*, 2, 449). In other words, Italians should *avoid*, not emulate, the French political mistakes and weaknesses.

At the same time, Cattaneo insisted that communal self-government is not enough. To succeed, the practice of local self-governance needs to be linked to and interpenetrate other larger self-governing institutions extending to the nation as a whole – what in the language of the *Federalist* was referred to as a compound republic (Ostrom 1987, 1991). Cattaneo considered “federal constitutional law” as the intellectual mechanism for designing and operating a multi-constitutional political system with overlapping jurisdictions.

Through federal principles of organization, Americans had found an innovative way to organize multiple jurisdictions in relation to each other without recourse to a single chain of command and bureaucratic arrangement. This innovative way was for Cattaneo a fundamental discovery of the Americans, and this fact is the leitmotiv running through almost everything he wrote or taught. A federative polity so constituted was for Cattaneo liberty in action – liberty as “the plant of many roots” (Cattaneo [1860] 1965 *SP*, 4, 80). As he noted to a letter to a friend in 1851, “The United States is a great word that can cut through many problems in Italy and Europe and can prevent many controversies” (Cattaneo, to Enrico Cernuschi [1851] 1952 *EP* 2, 88). For as he put it,

Only two states, the American federation and the Swiss federation, have demonstrated, even in these troubled times, the ability to sustain themselves. There the general order does not invade the local order: it does not humiliate, discourage, or oppress. It does not create resentment. It doesn’t impose its will with the machinery of an insensitive force. It isn’t extravagant with capital nor does it impoverish the family. Since industry is not worsened, it can nourish the hand it exploits less avariciously and less meanly; and it can also venture advantageously into the



furthest of markets. Now it remains to be seen how well other peoples, predestined by traditions and opinions or imperative circumstances to other forms of government, can nonetheless approximate this idea of brotherly law and high economy. It remains to be seen how much more honest and extensive one can render the practice of freedom, how much more natural and enduring one can render popular consensus, so as to spread interest in the deliberative processes of government and to attract the maximum number of thinkers and interested people to it (Cattaneo in Salvemini 1922: 87–8).

At the same time, Cattaneo's experience under foreign occupation made him especially sensitive to what to look for in the way of unobtrusive, hidden, foundations of self-governance could be found in civil society.

*Uncovering More General Foundations of Self-governance.* In the second half of 1830 that Cattaneo began to construct for himself a more systematic framework of analysis, informed by his polycentric and federalist conception of the human condition. Here I can only give a brief sketch.

First, Cattaneo argued, there is a need to discern between institutions that are accidental and transitory and those without which a human society cannot stand. The way to identify which mechanisms are foundational to human existence is to focus on how human beings the world over deal with questions of complementarity, interdependence and coordination. For Cattaneo, a common language as “the first element in social aggregation” is one such mechanism (Cattaneo [1837] 1948 *SL*, 1, 210–11). People had solved many problems of living together and acting in concert (*convivenza civile*) through all sorts of human associations, including communal societies and societies of neighbors – and these have existed beyond the family and kinship groups, and prior to the consent of state rulers and legislators.

A second set of theoretical factors had to do with being open to the possibility – Cattaneo at times called it a “generous persuasion” – to appreciate the constitutive dynamics of human beings in the world. Cattaneo argued that we should stop treating individuals as blind instruments of a particular time or culture while at the same time remembering that they are not self-sufficiently alone or metaphysically independent of society. The pressing task is to construct a public science or political economy incorporating history, institutions and culture and, at the same time, individuals as beings capable through their actions of destroying, derailing or refashioning the heredity of the past and existing equilibria. His conception of the individual links being, becoming and acting (or behaving) to form a constitutive dynamics or, to use what Siedentop says about Tocqueville's somewhat similar conception, “virility” (Siedentop 1994: 141). This is another way of saying that Cattaneo sought to understand how individuals learn to be free; sovereign is the word he often used,



while living in complementarity, interdependence and coordination with others – in short, how to achieve *convivenza civile*. Interested as he was about the origins of words and the use of language, Cattaneo seldom forgot that the root of *incivilimento* is *civis*, the citizen. A common language is an important principle of aggregation but it is not sufficient, in France as in a united Italy, to achieve self-governing patterns of human relationship and to prevent domination and exploitation.

Finally, the constitutive dynamics of human beings that manifest themselves in the world – which he liked to describe as the field of human liberty – must be studied in context, that is within the specificities of particular time and place. The field of human liberty takes individuals to be potentially co-creators with God of the world they live in. By this he meant that much of the world in which humans live is artifactual – Cattaneo used the term *artificiale* to refer to artifacts shaped by human knowledge like agriculture, commonwealths and irrigation networks. But this artifactual world cannot be theorized *in vacuo*, as this practice has already produced much disorientation in the history of philosophy. Cattaneo was mindful of Vico's conclusion that "the natural law of philosophers is not the same as the natural law of people" (quoted in Fisch and Bergin [1944] 1975: 48). Nor can human and political artifacts be studied solely at the macro, national level, for the history of countries relatively free of foreign domination like Japan (at that time) reveals that "the independence of the state does not yet mean the liberty of its citizens" (Cattaneo [1860] 1957 SGG, 3, 61).

By contrast, the work of interconnected local institutions had over many centuries transformed the originally inhospitable Lombard Plain and created the social, economic and political wealth that Lombardy had achieved in his own lifetime. The Lombard Plain was really the artifactual creation of patient tillers of the soil as well as engineers and masters of canals – a display of human ingenuity had over the centuries created the soil for it too was not originally a gift of nature (Cattaneo [1845] 1956 SE, 3, 5; see also [1844] 1957 SSG, 1, 419–33). This experience validated for Cattaneo the often hidden foundations of self-government and human progress itself. It was a powerful reminder that "the culture and the happiness of people do not depend as much as on spectacular changes in the political surface as on steady action of certain principles transmitted unobserved through *secondary orders of institutions*" (Cattaneo [1847] 1956 SE, 3, 115; italics in the original).

In his 1844 considerations on the principle of philosophy, Cattaneo sketched in more detail his perspective on how to uncover the hidden foundations for self-governance in different societies (Cattaneo [1844] 1960 SF, 1, 142–70). He began by noting that every civilized nation embodies various organizing principles that aspire to permeate the state and make it their own. History and current human events offer many examples of

enduring contrasts among diverse organizing principles seeking to give direction and uniformity to societies. This heterogeneity of principles is no mere “ideology” but a concrete manifestation of the multiple economic, juridical, cultural and moral dimensions of society. Cattaneo offers many examples of the multidimensional and complex world in which people live. He then introduces two important corollaries.

The first corollary is seldom if ever some social force tends to dominate and direct public life, as much as it may aspire to do so. Before one set of interests acquires dominance in the intellectual and public realm, including public opinion, others emerge often unexpectedly, pushing the current of interests and opinion in other directions. The second is that the more civilized a society is, the more numerous are its organizing principles it contains. This is what made the European civilization “superior” or stand out when ranged alongside the other major world civilizations. Guizot ([1828] 1997) had advanced the same argument.

Cattaneo was quick to point out that stationary peoples and societies do not exist except in the abstract or in the minds of some theorists. Cattaneo rejected the “Chinese stagnation” metaphor that was extremely widespread in 19<sup>th</sup>-century political thought and used by Tocqueville, Mill, Herder, Hegel and many others. He did so by calling up the resource-based achievements of the Chinese, requiring considerable human artisanship (Cattaneo [1861] 1957 SSG, 3, 150–1). He went even further.

Just like Lombardy, the China we know from history books is an artificial creation, made by successive generations of people acting in concert – whether establishing human settlements, digging up canals, creating cities, or fashioning laws, arts and writings. The history of mankind is more similar from country to country than we commonly believe. The type of progress open to human beings varies as a function of the course of events and structure of thought specific to particular time and place, and not as a function of racial or natural predestination – Herder and others notwithstanding (Cattaneo [1861] 1957 SSG, 3, 151). The critical difference, then, is the plurality or heterogeneity of constitutive elements making up a society that can serve to denote the potential level of progress in a society. A closed epistemic system is death. In part for this reason, Cattaneo argued that those who invoke perpetual peace, through a single universal republic, would reduce the world to an impossible situation.

The 1844 essay also offers theoretical and philosophical clues that help to explain why he was of the view that the American discovery of federal principles applicable to large territory was potentially applicable elsewhere. Cattaneo regarded movement and plurality (or heterogeneity) as the life-giving forces of human society. The antithesis between civilization and barbarism is here, and with it the future of individuals and peoples. If in his own time, Cattaneo noted, Europe had become synonymous with civilization and Asia with barbarism, this is so precisely because movement and

heterogeneity are present in the first and are reduced to the minimum in the latter. Why this is so? How to explain stagnation?

Look, Cattaneo said, to what afflicts public urban life in Asia today. The chief problem is not that those cities lack commerce, industry, a certain tradition of science, love of poetry and music, gardens, perfumes and the opulence of palaces and civilized lifestyle. The chief problem is that people have neither freedom nor autonomy; cities are without their urban law and, as a consequence, without municipal consciousness and patriotism. Most urban dwellers have been conditioned to live as if they were inanimate beings, as if they did not have a capacity to take individual and joint initiatives. European travelers who have depicted residents of Asian cities as resigned to their fate and unsolicitous about matters of common interests have been correct in their description, but seriously mistaken in explaining the causes. Communal apathy and inertia do not flow from personal characteristics, or even from community ethos. Fatalism, inertia and apathy do not derive from an innate incapacity or inability of Asians. Rather, they derive from the dominant organizing principle of political life and institutional arrangements that shape the political economy of everyday life of most ordinary people. Cattaneo identified the chief problem in the rituals of filial piety toward the emperor, or a descending conception of filial piety that stagnates an entire nation.

Cattaneo seldom lost faith in the view that human beings in Asia, as elsewhere, could learn to break out of such vicious circles (Cattaneo [1858] 1957 *SSG*, 2, 395). The chief difficulty is that the problematics of change and reform cannot be reduced to simple formulas. The play of principles that impact on society is not, properly speaking, dialectic. Changes do not occur this way; they occur rather slowly, unevenly and in a piecemeal fashion.

Heterogeneity, then, is both the result and a source of good institutional design. Cattaneo continued to use the term "state" but defined it as a set of fundamental rules that allow the many elements of social life to have an autonomous, self-governing existence while playing their part in society. The state is then, for Cattaneo, an immense interaction through which property and commerce, what can be held and what can be disposed of, luxury and savings, the useful and the beautiful, operate everyday seeking either to gain or defend spheres of public life that enhance their respective place and exigencies. And thus the supreme formula for good government and human progress is to insure that no set of interests and way of life acquires monopoly and overrides and denies space to others. Just as important, there is the need to so structure public life so that the pursuit of individual interest can be made to serve to serve the commonweal. For this reason, Cattaneo took pride both in the reformist tendencies of the Milanese Enlightenment and in the long-enduring institutions surrounding the Po River – where the collective-choice mechanisms had been so struc-

tured as to allow public officials to invest in maintaining and even crafting better rules for action.

The science of association suggested by all such undertakings could be strengthened and extended with the reiteration of federal design principles of organization in Italy as in Europe. This is why against all odds, Cattaneo continued – as he had promised to a friend in 1849 (Cattaneo [1849] 1949 *EP*, 1, 350) – to place trust in design principles and to hold firm to a positive view of life, if only for others yet to come. He was so confident of his vision that at one point he advanced “a grand prediction: Europe either remains autocratic or becomes the United States of Europe” (Cattaneo [1850–51] 1957 *SSG*, 2, 147).

### Francesco Ferrara’s response

As the chain of events weighted the making of Italy in favor of a unitary and monarchical state, the constitutional choice was between centralized and “decentralized” models of government. Perhaps nowhere else as in Sicily was the choice of rules that apply to the organization and conduct of government most felt and debated. Sicily had been, until 1816, when it was formally annexed by Naples, a more or less independent realm, with perhaps the longest continuous tradition of representative institutions in Italy. Sicilians had joined the cause of Italian unification only in 1848, when the possibility of creating a United States of Italy offered prospects for regaining independence from Naples, for securing protection against the recurrent problem of war, and for being part of a larger political community which respected the need for local and regional self-governing capabilities. In short, Sicilians had become Italian nationalists because of federalism. Now, following Garibaldi’s landing near Marsala, the Piedmontese saw themselves as coming to deliver Sicily from bondage. Many Sicilians, instead, came to fear the same process as a change from the yoke of Naples to the yoke of Piedmont or of Italy.

Francesco Ferrara (1810–1900), perhaps the ablest political economist of 19<sup>th</sup>-century Italy, was one of the Sicilians who took part in the debate about what rules and what constitutional design were best suited for Sicily. In July 1860, as Garibaldi began to rule Sicily in the name of Italy and Victor Emmanuel, Ferrara wrote a memorandum to Cavour, whom he knew from his years in exile in Piedmont following the collapse of the 1848 Sicilian uprising. The memorandum, entitled “Brief Notes on Sicily,” was written on about 8 July 1860, and was circulated anonymously in Sicily during that summer. It was eventually published in Cavour’s papers, from where it is cited here (Ferrara in Cavour, 1949, I, 296–305).

The memorandum outlined several possible ways of uniting Sicily to the nascent Italian realm. In effect, Ferrara accepted the constitutional monarchy and, by implication, its system of government and administration – what Carlo Cattaneo, with a stronger commitment to federalism and

federal republicanism, steadfastly refused to accept. Still, Ferrara's memorandum remains important because it elucidates what constitutional knowledge was available, and the problems that confront people in the design of governmental arrangements: namely, to know how different or alternative sets of principles articulated in correlative forms can be expected to yield what results. Ferrara suggested four ways of uniting Sicily to Italy.

The first was patterned on the Swedish-Norwegian case, which would have involved a union of Sicily with the Italian kingdom, much like the King of Sweden was also the King of Norway. There would be no union of the institutions of each kingdom. Although this solution was one that "every Sicilian desire(d), but no one ask(ed)" (p. 298), Ferrara suggested that it should be rejected. It would be less profitable to the interests of Sicily and even more damaging to the interests of Italy.

Ferrara equally rejected a constitutional design patterned on the French political and administrative experience. That would have meant complete fusion. Sicily would become just another province of Italy, as had happened to Lombardy and Tuscany. Ferrara informed Cavour that, though this solution was one that Sicilians asked for when they said "annexation," very few Sicilians, in fact, desired it. "The principle of fusion with the North now being preached is the very negation of liberty, concealed under the invocation of liberty itself: it is even a form of political socialism. It would be a fatal error if Italians showed that they could not emerge from the excesses of municipalism without throwing themselves into the other extreme, where unity is confused with absorption. ... (p. 299). Ferrara then turned to two other constitutional designs.

One was the Scottish system. That meant that Sicily would, with the exception of the authority of the national parliament, keep its secondary laws and institutions. Ferrara was sceptical that this experience could be modeled to work in Italy, revealing, in passing, something about his grasp of British affairs. "In our eminently Napoleonic epoch" (p. 302), it would be futile to entertain similar expectations from a general parliament of Italy. This led Ferrara to consider a fourth alternative constitutional design that appeared to have none of the shortcomings of the previous three designs. He called it "the American system."

When applied to the Kingdom of Italy, the design principles of American federalism would mean decentralization of power from national to regional and local governments. This was a way of reconciling Sicilian and mainland political aspirations. Unfortunately, in the memorandum to Cavour Ferrara offered a sketchy and inadequate portrayal of how the design principles of American federalism would actually take shape and work in Sicily. He did, however, indicate to Cavour the basic principle on which such an experiment could be carried out and some of the reasons that made it desirable.

The starting principle was the following: “nothing that is truly necessary for the expression of the Italian nationality should be taken away from the general parliament of Italy; nothing without proper cause should be taken away from the expression of Sicilian self-governance” (p. 303). The application of this principle to Sicily would neither lower the dignity of the monarchy nor make Italy less compact. “It is,” Ferrara averred, “a common error to attribute more cohesion to a state whose central government takes on tasks that subaltern bodies or individuals can do better” (p. 304). He emphasized the importance that citizens’ consent and trust play in the creation and maintenance of a viable constitutional order, and advised Cavour that “(w)hoever knows (Sicily) well must be convinced that annexation, on conditions which Sicilians might later regret, would soon generate sentiments not wholly Italian, which interested parties would not omit to nourish” (p. 304).

“The American model,” Ferrara stressed, had two crucial advantages over all other constitutional designs: it secured to the Italian union a calculus of consent from the people of Sicily *and* reconciled Sicilian and mainland political aspirations. Ferrara also looked to the future, and anticipated a third, more long-term, advantage accruing from the experiment of applying the design principles of the American political experiment to Sicily. In his own words to Cavour,

Who can ever tell that the solution currently being advanced for Sicily might not, some day, be extended to other parts of the peninsula? Certainly, ideas of rigid centralization are not native to Italy ... and no other part of Italy is as distinctive as Sicily. The Italian government could profitably carry out an experiment there which could do no harm. It might be a source of precious information for the future, if it ever came the day either to proceed to other annexations ... or to decentralize government in some of the regions already annexed (p. 304).

Ferrara’s prognostication takes on new meaning when viewed in light of the creation of the Italian regionalist state after World War II.

Cavour neither acknowledged nor answered directly Ferrara’s memorandum. But, writing to a friend of Ferrara, Michele Amari, Cavour dismissed Ferrara’s analysis with the following observation: “If the Italian idea has no influence in Sicily, if the idea of building a strong and great nation is not appreciated there, Sicilians would do well to accept the concessions offered by the King of Naples, and not unite themselves to people who would have neither sympathy nor esteem for them” (p. 305). The problem was that Sicilians could neither go back to the Bourbon monarchy nor turn away from the Savoy monarchy. For different reasons, then a united Italy based on federal design principles, whether *à la* Cattaneo or *à la* Ferrara, could not be established.

## **Eclipsed but not defeated: the continued attraction of federal design principles**

The victory of centralized government and administration in the making of a united Italy eclipsed the prospects of an Italian federal union. But that victory did not dim the attraction of federal design principles for resolving issues of self-government. The case of Enea Cavalieri serves to illustrate the point.

Enea Cavalieri was one of the first European analysts to examine the Canadian Confederation. He interrupted his Sicilian travels with Sidney Sonnino and Leopoldo Franchetti in 1876 to travel to North America. Reflecting on what he found in North America, Cavalieri expressed his understanding of federal principles this way:

In North America thanks to the federal tie there has been greater move for the resolution of the problem of disarmament and the maintenance of peace than we have in Europe with the emphasis on the balance of power and the discovery of the principle of nationality. It is the special nature of the federal agreement that creates a strong and supportive national unity at the same time when it respects and guarantees the autonomy of the parts that form the union, and translates relationships between states in beneficial and mutual productive relations. This is the principle that underlies federalism in North America. Representation in the national government must be the direct emanation of the people and not of the constituent powers.

Cavalieri continued,

There are many other issues in the theory and history of the constitution of the United States that merit the attention of Europeans: namely, the form of government, the division of powers within and across states, the prospects of institutional reforms and individual liberties (Cavalieri 1880: 431–2).

The Canadian federal experience was all the more interesting that it had taken place within the British empire. And, at the end of his travel throughout what was then Canada, Cavalieri reflected on this experience this way:

I had expected to see in Canada the French Catholic and the mostly English Protestant live side by side and under one flag. But I was somewhat surprised to find how the once desolated territory was becoming a prosperous land teeming with people and with little or no domestic interference from the imperial power that formally has controls over it.

Nothing had prepared me to understand the true meaning of the union of various colonies in one and great Dominion, and of the idea of peace that we in Europe take it to be constituted either with the balance of power approach or with a single political nationality. Neither the beautiful pages of Cotta about the American war of independence, nor the interesting travels of Mackenzie and Franklin in the upper parts of Rupert Land, nor the part that Nova Scotia affairs had played in the web of events and wars involving France and England had prepared me to understand what has taken place in Canada.

It is the special nature of the federal pact that creates a strong national unity at the very same time that it is respectful of local diversity and ... even the continuation of a colonial link (Cavalieri 1880: 31–2).

Cavalieri suggested the need for Europeans to pay attention to the Canadian federal experience for what it could teach and offered to monarchical and Catholic Europe, for Canada seemed to have succeeded in overcoming what in European history and politics had often been intractable issues: the maintenance of peace with undefended borders; the prospect of peaceful coexistence of two nations, two linguistic groups and two religious faiths working together in one single political entity which was itself part of a larger empire. Cavalieri also noted that nothing he had read in the history of political theory prepared him for the Canadian binational and bicultural experience (Cavalieri, 1880: 31–2). But just at about the time that Cavalieri's words were reaching the cold finality of print in Italy, the New Federalism of the Canadian Confederation was being challenged from within. By the 1890s Canada itself was in question. It is a challenge that has persisted (Sabetti 1989).

## **Implications for democracy in contemporary Europe**

That Tocqueville, Cattaneo, Ferrara and Cavalieri, independent of one another, were attracted to the North American experience of federalism and acquired a common vision and framework of analysis constitute a powerful reminder about the extent to which certain ideas, perspectives and aspirations about self-government and human liberation cut across accidents of birth, generations, political preferences and national boundaries. Their ideas and respective mode of analysis were not shaped by a narrow, intra-academic agenda but by the great social and political transformations of their time. In this, they were much like John Stuart Mill. Unlike Mill, however, Tocqueville, Cattaneo, Ferrara and Cavalieri were reluctant to grant that the choice of liberties is best made through representative political institutions. The North American federal experience furnished them the key to suggest a new political science appropriate to



a self-governing society and to advance the argument that such a self-governing society was empirically possible.

Cattaneo, Ferrara and Cavalieri did not merely seek to fashion a new theory of knowledge. They sought to provide a deeper structure to the paradigmatic shift required for the constitution of open societies in and beyond Italy. Their aim was not just to inform but to move people to act based on sound political principles of self-governance. In this, they did not succeed. It was left to others, well after they were gone, to be inspired by their work and to extend the analysis. The knowledge of how to extend principles of self-governance to large populations and territories – that is, how to bring together, and allow to work separately and jointly micro- and macro-institutional arrangements – exists. The problem remains: how to remove impediments for this knowledge to work itself out. The practical steps in democratizing a nascent European union are not easy to take (Schmitter 2000). Siedentop is right in fearing the emergence of a United Europe based on statist or parliamentary principles (2000). The grand prediction that Cattaneo advanced still stands: “Europe either remains autocratic or becomes the United States of Europe” (Cattaneo [1850–51] 1957 *SSG*, 2, 147).

## Notes

- 1 Robert P. Kraynak (2001: 46–52) raises serious doubts about the tendency to treat the Hebrew covenant (*brit*) as some kind of prototype of democratic consent or social contract. He argues that, in so far as the covenant with Israel sanctions specific forms of government, these are illiberal and undemocratic (see esp. p. 47). For a rejection of this view, see in particular Allen (2005).
- 2 For an extended discussion, see chapter 3, entitled “The Constitution that Did not Happen,” in Sabetti 2000b: 54–87.

# 3

## “Thinking Federally” from a Governance Perspective

*Susan E. Clarke*

### Overview

The surge of interest in federalism as a political idea and institutional design option in a remarkable range of settings – from Italy to Iraq to the EU – makes the question “which federalism” particularly salient. Federalism’s appeal as a political solution in such diverse settings underscores both the plasticity of the federalism concept, alongside the formalism of federalist political structures, as well as its contested nature. The evolutionary pattern of US federalism highlights these features: even within the US context, views of federalism are very much “in the eye of the beholder” and continually at the core of contemporary political debates. As Martha Derthick (1996), one of the foremost federalism scholars, sees it “American federalism is complicated and unstable.” In both established federal systems as well as newly federalizing governments, therefore, it is reasonable to approach federalism as an ongoing project as much as a formal prescription for allocation of authority and responsibilities.

Federalism’s increasing appeal, it is argued here, can be understood in terms of its advantages in addressing governance dilemmas. Linking federalism and governance concepts increases our ability to “think federally.” Taking a governance perspective on federalism underscores the institutional design features of federal systems that make federalism amenable to accommodating governance strategies. This essay sketches the basic dimensions of a governance perspective, the central premise being that *governments* are increasingly interdependent with other public and private actors – *governance* processes therefore require that actors seeking mutual gains find ways to coordinate their efforts. Thinking of federalism from a governance perspective moves beyond a state-centric approach to federalism to reflect the distinctive decision contexts and constraints facing public leaders. It provides better specification of the leadership tasks now demanded by these new contexts and the normative issues of accountability, legitimacy, and sustainability attendant to governance configurations.

Thinking about governance from a federalism perspective recognizes that these governance efforts increasingly are across scales or jurisdictions. To be useful, governance arguments must take into account the spatial nature and context of these increasingly multi-level governance processes. Institutional designs featuring federal elements appear to offer the flexibility and problem-solving capacities demanded by this new decision context of complexity, interdependence, and uncertainty.

To the extent that some of the most important federalism issues in the 21<sup>st</sup> century will have to do with governance dilemmas, clarifying the strengths, difficulties, and opportunities created by governance arrangements is an important priority for academics and practitioners.

### **Which federalism? Federalism as a metaphor**

To an unusual extent, the concept of federalism lends itself to metaphoric exercises and perhaps excesses. Metaphors of federalism abound, with more recent metaphors reflecting governance processes as well as structural configurations.

#### **Which federalism metaphor?**

Generations of American students waded through characterizations of “picket fence” and “marble cake” federalism, depicting different views of the distinctive relations and interdependent functions of federal units. As these interdependencies increased and become more complex, the homely marble cake metaphor has morphed into images of federal linkages as webs, mosaics, and matrices. Federalism metaphors can convey messages about the emergence of these linkages: To Tocqueville, Americans exhibited an instinctive if ambiguous federalism although Diamond (1973) considers these historical patterns to reflect an “ambivalent federalism.” More recently, “intentional federalism” leads to new political institutions such as NAFTA, GATT, and potentially a United Europe. Metaphors also signal the nature of these linkages: Kincaid (1990) refers to “coercive federalism” while Glendening (2001) is more likely to see “pragmatic federalism.” In an altogether different vein, Rubin (2001) declares Americans prefer “puppy federalism,” a feeling like young (puppy) love that overlooks harsh realities – in this case, the abandonment of true federalism for a centralized administrative state – in favor of nostalgia and sentiment. Claims of a “moral federalism” (Hendrickson 2002) point out, however, that assumptions of centralization are misplaced on moral issues: localities frequently resist and contest any national efforts to regulate morality issues such as medical marijuana, abortion, and gay rights. References to “menu federalism” (Congleton *et al.* 2003) emphasize ongoing negotiations and political agreements between government units on the assignment of policy-making power. Peirce (2003) now sees “federalism as Hell,” with *The Economist* (2003) referring to the more secular expression “the

F-word” and other scholars seeing contemporary American federalism as “Disneyland” (Fino 2003).

The distinction between public and private sectors is recognized increasingly as a “fuzzy” boundary (Bozeman 1987). More recently, the metaphor of “fuzzy federalism” (Coghill 2004) is used to characterize relations within and among these arenas. This draws on theories of fuzzy logic to characterize processes where decisions must be made on the basis of approximate, imprecise information and uncertainty.<sup>1</sup> The roles of information, trust, and negotiation among interdependent actors become as salient as constitutional frameworks in reaching decisions. These fuzzy boundaries, to some (LaPorte 1996), cast theories of federalism as forms of a sociological network theory.

### Why so many federalisms

If we consider these metaphors as framing the normative and empirical dimensions of the federalism concept, they serve as organizing devices to make sense of increasingly complicated political dynamics. Using these metaphors can also mobilize supporters to change political arrangements in some fashion. Implicitly, each metaphor provides insights on the institutional designs and functional arrangements of alternate federal configurations. These differing characterizations reflect the continued debate over the meaning of federalism as a set of political principles and as an institutional design. Increasingly, they also direct our attention to governance issues in federal systems.

### The contexts encouraging federalism and governance

Federal systems operate in a context of greater economic, social, and political integration on a supranational and global scale. The renewed interest in federalist structures and in governance strategies appears to be in response to the impacts of these forces on decision contexts. Globalization creates new conditions under which decisions must be made – interdependent, complex, loosely linked actors and institutions with shared purposes but no shared authority – and makes such decisions more problematic.

The central premise of the governance concept is that *governments* are increasingly interdependent with other public and private actors – *governance* processes therefore require that actors seeking mutual gains find ways to coordinate their efforts. The problem addressed by governance arrangements is the need to generate “enough cooperation” (Stone 1989) to make effective decisions under these distinctive conditions – that is, crafting decision processes that satisfy shared purposes, that reduce the costs of making complex decisions, and that are seen as legitimate and fair by those involved.

Government is not enough, according to governance advocates. Governance processes supplement traditional governmental procedures;

they are instrumental and strategic responses to the greater complexity, fragmentation, uncertainty, and interdependence in decision contexts. Governance processes, however, do not emerge independently of political, social, economic, and cultural forces. Rather, they are amenable to design and direction. To many, institutional designs featuring federal elements offer the flexibility and problem-solving capacities demanded by this new decision context and are conducive to supporting a range of governance strategies.

### **The governance game**

Governance concepts are now familiar elements of scholarly arguments and policy debates (e.g., EU 2001). But governance should not be considered a new phenomenon: it is more likely we are seeing the reconfiguration of state, market, and civil society relations around certain values, processes, and institutions rather than the emergence of distinctive new forms. It is not so much a question of whether there has been a process of governance in the past but how the process has evolved and the contemporary consequences of emerging forms (Pierre 1999). All governments are linked to many different organizations at different scales; few can act effectively solely on the basis of formal political authority.

Indeed, advocates from different ideological persuasions use this governance terminology; by seeming to be all things to all people it risks meaning nothing in particular. But its utility stems from the premise that governments are interdependent with other public and private actors – governance processes require that actors seeking mutual gains find ways to coordinate their efforts. In contrast to the traditional notion that governments necessarily and always act solely from their sovereign authority to autonomously formulate and design policy responses, a governance focus emphasizes the more complex processes by which goals are achieved in a global context. And in contrast to managerial emphases, a governance perspective assumes extensive and dynamic participatory processes and consultation. The most fruitful use of the governance concept, therefore, is not to restrict its focus to jurisdictions, decision-makers and organized interest groups but to recognize the important roles of a wide range of non-state actors in decision processes.

Governance is neither a causal theory nor a new normative framework (Stoker 1998: 18; Grell and Gappert 1992). Rather, it is more of an organizing framework to understand the changing processes of governing and to map the new realities of federalism in a global era. Conventional federalism concepts tend to assume a rather stable and consistent set of institutional arenas; they also traditionally focus on electoral forces and political bargaining among state officials. In contrast, a governance perspective on federalism emphasizes the multiple state and non-state actors involved in

decision processes at all scales, each characterized by greater complexity and interdependence.

This does not imply that formal political structures and relations are no longer relevant. Governance instead suggests that a broader range of political institutions and dynamics have become more important than traditional nested federalism models anticipate. Corresponding to the argument (Agranoff 2003a) that we need to understand what governments do rather than what formal constitutional arrangements prescribe, we need to understand governance arrangements rather than focus solely on governments themselves.

The argument developed here parallels Hooghe and Marks (2003) characterization of the diffusion and reorganization of state authority as institutional design alternatives they label as Type I and Type II governance. Both types aim at limiting the transactions costs of interjurisdictional and cross-scale coordination but have different implications for democratic practice. Type I governance approximates federal arrangements: “it bundles competencies in jurisdictions at a limited number of territorial levels. These jurisdictions form part of a systemwide plan: They are mutually exclusive at each territorial level, and the units at each level are perfectly nested within those at the next higher level.” In contrast, Type II governance entails provision of public goods by many functionally discrete jurisdictions and organizations in the absence of “an overarching blueprint.” Type II governance involves task-driven, intersecting, and flexible jurisdictions or organizations operating in a network rather than hierarchical fashion.

Hooghe and Marks’ schema clarifies the larger intellectual issues raised in asking “whose federalism?” They see Type 1 and Type II governance as co-existing – the argument presented here – but producing different types of outcomes, based on different concepts of community and their organization around (usually) territorial community (Type 1) or policy tasks and problems (Type 2). Their argument, however, is limited to jurisdictional design whereas the line of reasoning here recognizes diffusion of authority not only to other jurisdictions but also to non-state actors. Tracing out the different dynamics in each type of governance, as in the following sections, illustrates how federalism and networked governance are complementary rather than mutually exclusive institutional options and, indeed, how federalism shapes network strategies.

### **Attributes of governance processes**

Culling from the literature on governance processes,<sup>2</sup> we find some consensus on these critical elements:

*Multiple Actors/stakeholders:* institutions and actors within and beyond formal government institutions at different scales are involved in a growing number of decisions;

*Interdependence of resources and actions:* desired outcomes cannot be produced by one actor; rather they emerge from negotiations and exchanges among those with shared purposes and interdependent resources and power;

*Networks:* coordination is achieved through networks spanning public and private realms and different scales of activities; these are often self-organizing, interorganizational networks that can be steered but not controlled by governmental authority;

*Blurred Boundaries of Public and Private:* in this networked, interdependent, complex governance process, the boundaries of public, private, formal and informal sectors become blurred; as a result, the relations among these sectors shift, most notably the balance between state and civil society;

*Need to Coordinate in order to Achieve Goals:* in this complex and uncertain setting of tangled networks and blurred boundaries, there is value added in combining resources to achieve goals rather than acting alone;

*Collaboration is between clusters rather than sectors:* more organic governance arrangements build collaboration by linking clusters of stakeholders rather than bringing diverse stakeholders together in one entity (Potapchuck *et al.* 1999);

*Shared Purposes but no Hierarchy:* with no single sovereign authority but a multiplicity of actors specific to each policy area, activities are supported by shared goals not formal authority (Rosenau 1992), these shared purposes become the basis for joint action in the absence of a hierarchy of controls;

*Negotiation and Interactive Decision Processes:* in the absence of any single actor or institution with the knowledge and resource capacity to tackle problems unilaterally and to set rules for others to follow, decisions are made by negotiations and interactive processes (Stoker 1998: 22);

*Building Consensus and Trust:* a significant amount of time and energy is devoted to building a foundation of consensus and trust to support negotiated, interdependent decision processes among multiple actors with shared purposes but diverse interests and no common authority;

*Similar Outcomes but Different Processes:* the outcomes of governance processes may be similar to those of traditional governmental institutions performing basic functions but the processes are distinctive (Stoker 1998: 17);

*Governance Without Government?* these features raise the prospect of governance without government (Rosenau 1992); this is an important consideration because of the implications for democratic citizenship and practice.

## Governance typologies

Although there is a contemporary tendency to equate governance with networks, analytically the repertoire of governance strategies for distributing the costs of making and carrying out decisions includes *markets, hierarchies, and networks* (Cox 1997; Rhodes 1997). This repertoire presents a menu of governance strategies for improving decision processes. In different ways, they reduce the costs of making decisions while increasing the capacity to act. Specifying “how governance is exercised” (DiGaetano and

Klemanski 1999) is essential to moving from descriptive accounts of governance to more analytical assessments.<sup>3</sup>

Despite the focus on networks, it is important to recognize that many issues continue to be resolved by relying on market mechanisms. Markets rely on price mechanisms to coordinate multiple, interdependent interests and resources and shared purposes. Price structures determine resource allocations and decision choices. Market-based public policies manipulate taxes and regulations to affect these decision processes in ways that address public goals.

As Table 3.1 indicates, governance strategies relying solely on market mechanisms seem insufficient for making interdependent, complex, negotiated decisions. Although reliance on market strategies will continue,

**Table 3.1** Governance strategies and governance tasks: issues

	Markets	Hierarchies	Networks
COORDINATION & COOPERATION: Issues	Use price mechanism <i>Efficient coordination but not necessarily cooperation</i>	Rules, norms, institutions <i>Public incentives can encourage coordination and cooperation at different scales</i>	Trust, reciprocity, informal coalitions <i>Mutual adjustment, reciprocity can generate coordination and cooperation among members</i>
STEERING: Issues	By strategic choices of larger corporations and more powerful nations <i>Tend to be short-term, ad hoc responses Negotiated decisions difficult to achieve</i>	Use administrative rules and institutions <i>Can become entrenched, inflexible Slow to adapt to new context</i>	Through coalitions, mutual adjustment, partnerships, linkages <i>Tend to issue focus v. larger context Legitimacy deficit Leadership gap for women, ethnics Citizenship rights unclear</i>
INTEGRATING: Issues	Bring together those relevant to maximizing profit goals <i>Risk and costs of long-term strategic guidance of multiple stakeholders and networks</i>	Political choice to focus on management of diverse institutions and networks <i>Prone to focus on internal affairs New institutional infrastructure may be needed Unclear payoffs for managing tangled networks</i>	Strategic choice to create federations, networks of networks <i>Linked webs with public or private sector can distort goals Accountability and legitimacy of integrated webs Less inclusive scope and autonomy</i>



governance through market strategies can lead to short-term and *ad hoc* responses rather than the long-term strategic guidance necessary when dealing with multiple stakeholders, tangled networks, and the need for negotiated decisions. In addition to market failures in providing public goods, markets also fail to integrate “at-risk” groups and areas and to draw on their human capital potential. Ultimately markets fail to address critical governance tasks of steering and integration. Accordingly, the following discussion primarily examines governance strategies drawing on network and hierarchical options.

If we put governance strategies on a continuum, with market strategies at one end, then hierarchical strategies are at the other end of the continuum and networks are in the middle. These positions are not so tidy in reality, of course. Although networks are often highlighted as soft policy options, the assumption here is that network governance is embedded in more hierarchical institutional terrains – such as federal structures – and shaped by hierarchical governance strategies developed by public authority. In Hooghe and Marks’ terms, but counter to their argument, Type II governance is shaped by Type I governance and cannot be considered as analytically independent.

### **Hierarchical strategies to ensure enough cooperation and coordination**

Hierarchical strategies use rule setting, norms, and institutional design to ensure cooperation and to coordinate decisions. The capacity to create hierarchical strategies rests in the public sector even though the governance arrangements created by these strategies need not be limited to public actors. Hierarchical strategies provide the traditions, norms, and practices that shape or constrain different policy alternatives.

Hierarchical governance strategies continue to be important. Indeed, globalization enhances the viability of governance strategies drawing on rule-setting authority and networking capacities. In contrast to market-oriented governance arrangements, these approaches allow public officials to create incentives for mobilization, coordination, and cooperation necessary for achieving public goals even in the absence of direct interventions. Federalism establishes rule-setting authority and institutional capacities across political scales – it legitimates the use of hierarchical strategies at different scales. Similarly, the creation of new rule-setting bodies at different regional and transnational scales – such as international agreements on ocean resources or binational environmental commissions in North America – internalizes the costs associated with making decisions under these new conditions.

Governance through hierarchical strategies can seem to lack flexibility and adaptability; indeed, the costs of establishing new rule-setting procedures and institutions are high. Nevertheless, many innovative political developments in recent decades stem from the use of hierarchical strategies to induce cooperation and coordination.

*Establishing New Institutions.* Calling on its rule-setting and institutional design capacities, governments can establish new organizations to ensure coordination and cooperation on issues involving interdependent resources, multiple stakeholders, and negotiated decisions. In the Piazza Grande neighborhood of Bologna, for example, a non-profit organization was set up to coordinate the public, private, and third sector organizations active in providing shelter and employment services for homeless people. The Greater Vancouver Regional District (GVRD) in British Columbia, for example, is controlled by its member municipalities through formal representation and administers critical regional services through Service Districts and inter-metropolitan coordination.

*Encouraging Collaboration.* Not all hierarchical strategies are top-down. Ostrom and her colleagues have established an impressive empirical record of efforts to manage common-pool resources in poor communities through institutional arrangements – hierarchical strategies – that enable people to cooperate over finite resources to which they have open access. Both incentives and sanctions are embedded in these institutions, as are provisions for increasing information and reducing the transactions costs of decisions. Many of these practices emerge from grassroots experiences; they are bottom-up strategies for creating shared rules and norms that people abide by out of rational self-interest (Stoker 1998: 23; Ostrom 1990).

Even in the United States, where fierce community competition for investment would seem to preclude hierarchical strategies to encourage regional and metropolitan cooperation, we find cross-sectoral, collaborative initiatives encouraged by both the national and state governments. The public sector still sets new rules and creates new administrative orders but in tandem with multiple stakeholders and often outside formal governmental arenas. Given the high degree of interjurisdictional competition in the US – and the promotion of more entrepreneurial cities elsewhere – any incentives encouraging more interjurisdictional cooperation are notable. One of the most prominent examples is the national legislation establishing the Intermodal Surface Transportation and Efficiency Act of 1991 (ISTEA) and its successor TEA-21. Both redirected national transportation funds from state control to regionally-based Metropolitan Planning Organizations and encouraged more multi-modal transportation planning.

### **Network strategies to ensure enough cooperation and coordination**

Networks are configurations of people and organizations pursuing a common goal or shared purpose in a collaborative manner. Networks use informal coalitions, trust, reciprocity, and mutual adjustment to produce cooperation and coordinate decisions. These processes are rooted in civil society although they are shaped as well by public and private sector configurations. Historically, these processes were labeled as “community,” presumably defined and circumscribed by territorial boundaries. In a global

era, coalitions and networks created from the bottom-up form non-territorial communities centered on shared problems and purposes. Networks of actors rather than governments or markets increasingly link global and local processes. Networks may prove superior to market and hierarchies – may have an evolutionary advantage – in coordinating interdependent, complex, loosely linked actors and institutions with shared purposes. Network governance strategies, therefore, can become integrative institutions. Not all networks, however, will have sufficient power and resources to take on these integrative functions.

As noted here, networks are not the only form of governance nor are they new devices. Coalitional strategies are common and essential traits in liberal democracies where power may be diffuse and fragmented (DiGaetano and Klemanski 1999). But they are increasingly significant coordination and cooperation mechanisms. As informal configurations, networks operate outside of formal institutional structures (John and Cole 1998: 387). Many networks are self-organizing but that is not an essential element; governments can establish new rules and incentives that encourage the formation and sustainability of network processes. To be effective, these coalitions and networks must achieve sufficient scope to encompass and coordinate the groups necessary for generating “enough cooperation” to carry out governance activities.

As in states and markets, networks display a distinctive rationality. They engage in continued dialogue to generate and exchange information, they attempt to engage government partners in a range of interdependent decisions over a mix of short and long-time horizons; and they encourage solidarity as a means of reducing the risks stemming from their interdependence and asset immobility. Effective networks engage in monitoring, learning, and adjustments both within and between networks. Thus network dialogues center on mobilizing consensus and building mutual understandings. When networks are effective, governments may give up some of their authority for more influence – steering and integrating – over economic actors participating in these arrangements.

Some of the network strategies most relevant to federalism include those extending across scales and jurisdictions.

*Networks Across Scales.* The typical role for non-state actors is articulating interests outside of political structures and independent of formal government processes. While this is a familiar activity to city, state/provincial, and national leaders, increasingly the organization of these actors and demands is not restricted by territory. Network-led initiatives, such as the “car-free days” on September 22 in Europe, linking 800 cities in 25 countries (Netd@ys), are voluntary assemblies of these diverse actors sharing a common goal but no common authority.

Many networks link cities together. Some linkages are for information exchange: Municipal International Cooperation (MIC) promotes point-to-

point municipal knowledge exchanges through international partnerships of cities. Others are strategic alliances of cities, such as Metrex and Eurocities in Europe and CITYNET in Asia (Friedmann 1997). Some interurban networks are initiated and supported by the European Commission and, for example, by the German state although these have been criticized as ideological projects rather than true network organizations (Leitner and Sheppard 2002).

Increasingly these city networks stretch across national boundaries to deal with problems that spill over jurisdictional lines. This often leads to networks' involvement in international networking and lobbying. Along these lines, the Social Platform promotes a more explicit role for civil society and non-governmental organizations in European governance strategies. FEANTSA (European Federation of National Organizations Working with the Homeless) lobbies European institutions and national governments while also supporting NGOs providing services to homeless people.<sup>4</sup>

Local groups focused on social concerns also network at the regional and transnational level. The Casa Pia de Lisboa project, for example, brings together public and private agencies, labor unions, business organizations, and universities to bring Cape Verde families into the political and economic mainstream. One goal is to legalize the families' situation in order to gain access to social and employment rights; Casa Pia also provides "customized," on the job vocational training as well as support for small business start-ups. Casa Pia is affiliated with IGLOO (Global Integration Through Housing), itself a joint initiative set up by three European NGO partners (FEANTSA, CECODHAS-ICAP, ETUC-CGIL) as a platform to encourage projects integrating housing, social support, training, and employment initiatives. The Platform of European Social NGOs, established in 1995, links over 1,700 organizations throughout Europe to promote social inclusion agendas.

FEANTSA and the Social Platform both exemplify the "network of networks" model: the Social Platform links existing federations and networks and builds alliances with other organizations and networks such as the European Trade Union Confederation and the Green Eight Environmental non-governmental organizations. The growing presence and capacity of "networks of networks" – new transnational linkages between existing networks and federations of civil organizations – is instructive (Barber 2000). To those seeking to enrich a European civil society, this requires a "civil dialogue" between non-governmental organizations and European level institutions, ultimately one given a legal basis and budgetary status.

*Interstate Networks.* Elazar (1996) noted a paradigm shift from statism to federalism, beginning after World War II and accelerating since the late 1970s. Diminished state sovereignty and more "constitutionalized" interstate linkages promoting economic integration take on a confederal

dimension, particularly as the EU evolves. Rather than states disappearing, Elazar anticipated states being overlaid by layers of confederal ties bringing them closer together.

These overlays are evident at many scales. In Europe, the megacorridors connecting the major urban areas present a special challenge for transnational spatial governance. Governance of these megacorridors involves diverse actors, strong intersectoral, public-private, cross-border, and central

**Table 3.2** Networks at different scales: advantages and issues

	Horizontal	Regional	Global
ADVANTAGES	Lower costs Flexible resources can be pooled Multiple, diverse members More community involvement Greater productivity More innovative Shared purposes as incentive to act Mobilize new actors	Fits economic realities Increases economic competitiveness of members Captures "surplus" generated at regional scale beyond political boundaries Expands voice of marginalized groups Draws on greater pool of expertise and participation Greater potential for lobbying various governments	Reconstruct democratic values on global scale Monitor and redress externalities of globalization processes Establish rule of law and rights of citizenship
ISSUES	<i>Displace representative democracy and electoral politics?</i> <i>Potential for demobilizing poor?</i> <i>Less flexible due to resource dependency?</i> <i>Gender biases?</i> <i>Accountability for performance?</i> <i>Weak internal democracy?</i> <i>Non-transparent decision processes?</i> <i>Inclusionary scope?</i> <i>Potential for marginalizing non-networked interests?</i> <i>Potential for steering?</i>	<i>Only bi-lateral v. linked networks?</i> <i>Only hedging against risks of not belonging v. actual commitment?</i> <i>Political sovereignty issues prevail?</i> <i>No regional identity?</i> <i>Democratic deficit?</i> <i>Citizenship roles?</i>	<i>Unclear roles of global civil society?</i> <i>Accept rule of law?</i> <i>Potential to reframe markets?</i> <i>Capacity to address social and economic disparities?</i>

– local coordination (deVries 2003). Cross-border and transnational governance agreements – Type II governance to Hooghe and Marks (2003) – can emerge even in the absence of supranational organizations. In North America, numerous Cascadia organizations linked the provinces of British Columbia, Alberta, and the states of Oregon and Washington even prior to the NAFTA agreements. The Pacific NorthWest Economic Region (PNWER) group, for example, was formed in 1989 by 60 British Columbia and North American legislators. These binational groups act collectively as regional political actors on specific issues such as immigration and transportation where their shared interests are obvious.

Following 9/11, PNWER brought together business and government leaders in its five states and three Canadian provinces membership to develop a regional protection, preparedness, and response plan – a Partnership for Regional Infrastructure Security (PRIS) (Gavin 2001). PRIS is cited as “a model for other states and regions seeking to bridge the gaps in emergency-management systems” traditionally funded and directed by the federal government and state programs for disaster assistance (*Ibid*). In addition to this problem of interjurisdictional coordination, PRIS is contending with a system of critical infrastructures in the Pacific Northwest that are primarily privately-operated and not subject to government control.<sup>5</sup>

As Table 3.2 shows, the gains of cooperation and coordination through networks rather than other governance strategies include potentially lower costs, more flexible resources, greater community involvement and pooled resources to increase productivity and innovation. This flexibility allows participants to respond to diverse situations and conditions with distinct solutions tailored to the context. With new information technologies, networks can be created and maintained with modest costs to participants; communication of “best practices” and innovative strategies can occur with relatively few burdens for those with access to these technologies.

### **Why governance? Why networks? Why now?**

It is reasonable to ask “why governance” and “why now?” After all, federalism is an old idea, a classic philosophy and institutional design grounded in values of democracy, autonomy, and efficiency. The waves of governance and network metaphors often appear to lack such value bases and certainly lack specificity and systematic research supporting their claims to be a better “fit” with contemporary realities. To add a governance perspective to our understanding of federalism requires some justification.

The growing importance of governance arrangements and processes is attributed, not necessarily in mutually exclusive ways, to the interdependency and complexity of contemporary decision contexts, the resurgence of civil society, the hollowing out of the state, diminished

national capacities, underdeveloped decision capacities at different scales, construction of territorial actors, and neoliberal political agendas.

### **Interdependency and complexity**

One of the most familiar arguments for a governance perspective emphasizes the need for adaptive systems capable of dealing with the complexity, interdependency, and uncertainty of contemporary decision contexts (UNDP 1997; Stoker 1998). Similar to the arguments for structural contingency, the assumption is that the internal structure of organizations will respond to these new decision contexts and environments. Formal bureaucratic structures appear less able to deal with the complexity and interdependencies in their environment, including the demands for participation and transparency.

Much attention is given to network governance modes because these bring together people with shared purposes to address complex problems requiring shared knowledge and collaboration. This often means leadership is shared as well, or at least distributed among the networked organizations. In addition to the features noted above as attributes of governance processes, networks often engage in learning processes that encourage reframing of problem definitions and better understanding of conditions shaping the context. They also are resilient and sustained over time, in part because members bring value added resources – new knowledge, new processes – back to their home organizations (Agranoff 2003b).

Governments retain significant roles, even in highly networked governance arrangements. In particular, only governments can steer and integrate network activities by thinking and acting beyond individual networks. Steering entails bringing the necessary actors to the table and then moderating differences and negotiating cooperation. Integrating tasks include managing diverse networks to ensure public goals are met by putting network activities in a larger context. Priorities set by new decentralized units, for example, may counter or conflict or compete with those in other areas as well as with national goals. Achieving leverage over a complex, fragmented system with expertise in the small units is a major task in itself.

### **The resurgence of civil society**

The “associational revolution” (Salamon 1994; UNDP 1997) – the emergence of non-governmental organizations as new bodies with their own legal status and position as partners in governance networks – is one of the most distinctive features of the global era. This increased involvement of non-profit, non-governmental, voluntary associations, and community associations sets governance processes apart from government decisions and market choices. Non-governmental organizations (NGO), in particular, play significant roles in civil society through networked governance

processes. In their “gap-filling” roles (Bebbington and Mitlin 1996), these organizations can be part of service-delivery systems and receive grants, contracts, and fees for services previously provided by the public sector.

### **Diminished national capabilities**

Frederickson (1999) calls the disarticulation of the state one of the most important features leading to the repositioning of American public administration. This disarticulation involves the declining relationship between jurisdiction and public management, with consequent declines in the capacity of the state to deal with complex issues. American public administration scholars have responded to these new conditions with greater emphasis on institutionalism as a framework for empirical research, network theory drawn from organizational sociology and business administration, and the governance concept.

In Europe, observations of these diminished national capabilities gave rise to analysis of multi-level governance processes. Wallace (1996) argues that multi-level governance processes are responses to gaps in the ability of national governments to control global and transnational economic processes. These gaps – stemming from the logic of new competition and production processes at a global scale and limited national sovereignty – allow other actors to influence how politics and economic forces play out at subnational levels. They also prompt efforts to coordinate actors at different scales and to channel decisions in situations of interdependence, indivisibilities, and uncertainty – efforts characterized as contributing to multi-level governance arrangements. As Wallace (1996: 11) puts it, the governance issue involves construction of policy responses at multiple levels of government, between public and private sectors, and possibly across borders. Such responses link state and non-state actors at different scales, relying on transactions among actors rather than prescriptions (Cappellin 1996). Governance arrangements and institutional responses to scale incongruities and decision interdependence constitute “the repertoire of existing institutional responses” (Sbragia 1992: 267) – the intersect, for our purposes, of federal structures and multi-level governance processes.

This argument implies that globalization pressures will push all governmental institutions toward multi-level governance processes, regardless of their formal institutional structure. Federalism, however, appears to offer an institutional framework more receptive and conducive to these multi-level governance processes. Even so, shifting towards structuring multi-level governance processes – both vertically and horizontally – and towards more decentralized political systems is not without its share of problems. Leonardi (2003), for example, attributes the slow spending rates for Structural Fund financing in southern Italian regions to the “haphazard transition” from a state-centered national regional policy framework to the EU’s multi-level governance strategy. Moving towards more “appropriate”



institutional designs results in an overlay of governance strategies and lagged institutional responses; both management principles (Leonardi 2003) and institutional incentives shift but not always in synchronization. Lagged institutional responses rather than adaptation may be the more likely consequence. Creating incentives to speed up this transition process, such as the  $n+2$  rule making transfers of Structural Funds to programs contingent on spending out previous allocations (Leonardi 2003), are likely to be necessary.

### **The hollowing out of the state**

To many analysts, the economic and technological changes attendant to globalization contribute to a "hollowing out" of the state in which supranational and local scales become more significant than national. The process resembles hollowed-out corporations with transnational headquarters in one country and operations elsewhere implicit in Reich's (1991) metaphor of the global web. But here the process is one of "hollowing out" of the nation-state as the locus of economic and political power is shifting *upward* to supranational institutions, *outward* to transnational networks of cities, and *downward* to subnational scales. Not that the nation-state withers away; national governments continue to control significant resources, including financial and legal rule-making authority. But important economic and political functions shift to other scales.

From this perspective, the inadequacies of national governments in dealing with these new economic processes are catalytic. Decentralization and devolution occur at this historical moment in part because of the inability of the central state to pursue sufficiently differentiated and sensitive programs needed by investors. The new geography of the 21<sup>st</sup> century is rooted in a paradox: globalization means regions and localities become more important decision arenas. This paradox, along with the argument that the work of globalization is grounded in the concrete realities of cities and regions (Sassen 1996), acknowledges new roles for nations, cities and regions in a global era. Cities and regions may well be the political arenas for negotiating democratic citizenship and national competitiveness in the global economy.

Globalization is a two-way street: not only are local fortunes shaped by global forces but nations, cities and regions are actively engaged in constituting global practices and processes. Public officials do more than "mediate" global pressures; they make strategic choices about resistance, accommodation, and adaptation to these forces (Beauregard 1995: 244). Increasingly, these choices center on governance processes in which the role of government and representative institutions is a variable rather than a given (Pierre 1998: 6). Local and regional governments play important roles in governance processes aimed at differentiating investment sites for potential development. They often control significant resources,

particularly over land use and development that are not amenable to networked governance arrangements.

### **Underdeveloped decision capacities**

Although the goal of governance is to accommodate a broad range of actors, it is possible that resources and decision capacity are underdeveloped at some levels. In these cases, supranational and national governments may empower existing subnational units as well as encourage the formation of new functional units able to capture the efficiencies and competitive advantages of operating at broader scales than existing territorial units. Decentralization of power, authority, and some functions from national to subnational governments, for example, is a critical aspect of this process (Dillinger and Fay 1999). The rationale for strengthening subnational governments is both political – enhancing democratic practices – and economic – more effective and efficient implementation of public policies.

Within the European Union, growing demands for new partnerships between different levels of government in Europe and more explicit roles for subnational governments in European governance led to the White Paper on Governance in the EU (2001) encouraging multi-level governance and enhanced decision capacities at subnational levels. These trends toward multi-level governance are promoted by subsidiarity principles; in effect these principles create incentives for mobilizing networks of non-state actors and power resources at different levels (Leonardi and Paraskevopoulos 1996).

As debate on the European Commission's 2001 White Paper on European Governance unfolded, the prospect of a "network Europe" emerged along with the need to design "new interactive forms of governance in Europe" with a stronger role for intra-State and non-governmental actors (Conference 1999). Efforts to improve decision capacities at different levels introduce design issues centering on the distribution of policy responsibilities among different territorial levels, coordinating the involvement of these new territorial actors in decision-making processes and policy implementation, ensuring the transparency of these complex decision processes, and encouraging citizen participation in these new arenas.

### **Construction of territorial actors**

Governance becomes more important as regional economies become more significant. The current wave of regionalism is grounded in the desire to enhance the competitiveness of economic regions in the global economy. In contrast to hierarchical strategies for creating regional actors or market driven processes, these regional initiatives tend to be cross-sectoral alliances where public and private sector stakeholders share purposes and see mutual gains from cooperation and collaboration at a regional scale.

The proliferation of regional networks and agreements across the globe reflects intentional and strategic political choices for new governance arrangements rather than the mechanical and simultaneous unfolding of globalization and regionalization processes.

Initial accounts of regionalism trends emphasized the transition to a knowledge economy, the emergence of collaborative clusters, and new roles for local and national governments as key elements (OECD 2001). But they overlooked the historical, social and political factors undergirding the apparent regional advantage of selected areas (e.g., Jones and MacLeod 1999). To the extent that state capacities are being reconfigured across scales, the new regionalism (Jessop 1997) shifts attention to regional and local governance processes and the networks of formal and informal actors involved in generating cooperation across scales.

A regional governance concept centers on these political processes and decisional capacities. It begins with the proposition that a new political space – characterized by complexity, fragmentation, interdependence, ambiguity, and risk (e.g., LeGales 1998; Storper 1997; Jessop 1995) – is emerging at the regional level. In some places, this space emerges in response to the incentives of extra-national institutions such as NAFTA, OECD, the World Bank, and the European Union as well as to the broader impacts of globalization and economic restructuring. The European Union's Committee of the Regions is one of the most prominent recent examples of empowering regional actors: the Interreg IIC and IIC program's funding provides incentives for national and subnational governments to cooperate and coordinate their efforts on a range of policy issues. In the absence of such hierarchical structures, much of the US debate, for example, is on whether the current "function-based regionalism" can evolve into a more coherent regional governance capacity (Wallis 1996). Although the presence of certain contextual imperatives or factors may promote regional outcomes (Foster 1997), the framing and interpretation of these conditions determines whether they will lead to the construction of new regional actors.

The regional governance issue is clear: under what conditions actors at this scale, in this political space, mobilize and coordinate resources sufficient to act purposively and collectively on mutual interests. This emphasis on state roles resonates with the focus on the new institutional landscape. Amin and Thrift (1995), for example, contend that institutional "thickness" is critical to regional capacity; this includes reflexive networks, structures of collective responsibility, and the emergence of cognitive mapping of a place that creates a shared agenda. By bringing the state into the regional debate, the rescaling of governance institutions becomes a political construction process. Regional governance capacity is not determined – much less explained – by the networks, partnerships, and other governance arrangements found in some areas and not others. Rather than

take these networks and partnerships as the “endgame” (Jones and MacLeod 1999), regional competition and the potentially exclusionary nature of elite-driven regional agendas becomes the center of inquiry. These new regional actors face a series of “Heavy Challenges” (Amin 1999). These include, among other factors, learning how to learn and adapt, moving from a culture of command and control to one that encourages a diversity of knowledge, expertise, and capability, broadening the institutional base, moving beyond rule following to a culture of informational transparency, consultation, and inclusive decision-making.

Situating regional governance in a federal context raises a number of issues: the role of national states, the construction of regional identities, the extent to which regions constitute “civic arenas” (Tomaney and Ward 2000) for policy debates, the economic and political impetus for regional governance formation, whether regional governance redresses the “democratic deficit,” and the evolution of regional governance in the absence of hierarchical authority. Recent efforts to implement homeland security initiatives in the US, for example, underscore the impact of regionalism in encouraging greater intergovernmental cooperation in this complex and uncertain decision context (Caruson *et al.* 2005).

### **Ideological agendas**

Another answer to the why now question emphasizes the ideological dimensions of network concepts. To Leitner and Sheppard (2002), this “network discourse” is part of a larger neoliberal agenda of enhanced economic competitiveness, a leaner state apparatus, and more flexible governance. As they see it, many networks are “created, regulated, and evaluated by state institutions;” the very multiplicity and extensiveness of networks makes them “effective channels for disseminating a neoliberal agenda” although they also create “new political spaces” for challenging these agendas. Furthermore, the network orientation tends to elide issues of race, gender, and class as well as ecological concerns; these are opportunities for self-organization but they are rarely the focus of network strategies.

### **Why federalism? Why now?**

While there is growing attention to governance arrangements, there also is a renewed interest in federal organizational principles. To some, federal structures are best suited to accommodate the complexity, interdependence, and uncertainty in decision processes also giving rise to governance processes. Several features of federal structures are highlighted in these arguments: federal structures encourage a problem-solving approach; the dispersed power in federal systems increases the potential for the emergence of innovative solutions and learning (e.g., Glendening 2001;

Leonardi and Paraskevopoulos 1996); and federal structures are more resilient and adaptive to complexity.

Rather than attribute such qualities directly to federal structures, the argument here is that federalism is more amenable to the types of governance arrangements producing these desired outcomes. In a sense, it argues that federal structures are the intervening variables making it more likely that basic governance arrangements result in these outcomes.

### **Federal structures and problem solving**

One of the purported virtues of more decentralized systems is the increase in decision-making autonomy and discretion and improvements in problem-solving capacities throughout a federal system. More autonomy is expected to “release energy” (Handy 1992). While these prescriptions are made in good faith, improvement of problem-solving capacities is problematic. Resources, skills, and time are necessary to develop these capacities. Even with decentralization reforms and targeted resources, however, problem-solving capacities may be slow to develop. One of the most important features slowing this process is the heavy hand of past policies; as Leonardi (2003) argues, the “less than brilliant” performance levels of southern Italian regions, even with substantial Structural Funds financing, can be traced to the lingering effects of previous national regional policies featuring sectoral development policies. This path dependency argument indicates that decentralization is not enough: greater attention to the mechanisms for adapting to and learning new policy approaches – particularly training, incentives – is a critical aspect of improving problem-solving capacities in decentralizing systems.

*The 49<sup>th</sup> Parallel: Eliminating the border in order to protect it.* A more remarkable example of problem-solving across two federal systems is evident in the aftermath of 9/11. Rather than muting cross-border cooperation discussions, the 9/11 attacks accelerated attention to cross-border issues and the ways in which economic growth and security values could be accommodated and promoted. While no one disputed the new urgency to security needs, the potential effects of heightened security procedures on the significant cross-border economic trade between Canada and the US were enormous.

Much of the post-9/11 debates centered on redefining the US/Canada border and emphasizing internal perimeters as the focus of security procedures.<sup>6</sup> To accommodate economic and security concerns at the ports of entry, a powerful cross-border governance network promoted the notion of a “smart border.” The private sector in Canada and the US played an important role in bridging economic and security values by supporting the notion of a “smart border” and articulating a view of the border as a perimeter rather than a boundary. With the goal of building a “smart border,” one allowing the secure flow of both people and goods, US and

Canadian officials committed to smart technologies, joint investments in border management programs and potential joint staffing of border inspection and security offices.

The smart border concept redefines the border as a perimeter with extensive internal controls and preventative “point of origin” border control policies. Over time, the notion of “smart borders” became enmeshed with “perimeters”: efficient movement of low-risk goods and travelers depended on moving processing away from the physical border (Coalition 2001: 1). This concept was a mainstay in border policy discussions before 9/11 (e.g., Flynn 2000; Papademetriou and Waller 2001); after 9/11, this argument appeared to promise a technological fix to the difficulties of protecting such an extensive undefended border.<sup>7</sup> This solution to cross-border economic and security issues, however, also appears to signal the federalization of border control policy by merging emergency preparedness, disaster planning, and law enforcement officials. Strengthening these internal controls on both sides of the border is intended to increase both security and economic mobility. It “regionalizes the state” in a fundamental sense, by extending and strengthening the functional border into a perimeter reaching deep into each nation.

### **Federal structures and learning networks**

Learning networks feature institutions and organizations capable of adapting to new conditions and uncertainty and exhibiting sufficient trust and mutual knowledge to act collectively in response to these changing contexts. More decentralized federal systems are presumed to encourage these learning networks because decentralization of decision-making provides, in itself, incentives to mobilize and act (Leonardi and Paraskevopoulos 1996).

Americans frequently argue that their decentralized federal system creates “laboratories for democracy” in each state: the absence of a strong national role encourages innovation and creativity in state and local governments. Although these power relations wax and wane, the assumption is that subnational governments enjoy the responsibility and the power to take the lead on a wide range of policy issues. There are more incentives to become more innovative, given the greater autonomy, discretion, and lack of oversight. Distributed authority encourages the development of pools of expertise rather than centralizing expertise and talent. With more diversity, more options are available. Through both cooperation and competition, these innovations are diffused to other states and local governments.

To some, this innovative capacity can be hampered by national policy agendas. National programs and regulations – particularly unfunded mandates and funding obligations – limit subnational innovations and deflect energies and resources away from areas in which subnational governments might be more effective (Nivola 2002; Derthick 2001). Certain national

regulatory strategies constrain local autonomy and hamper their abilities to deal with routine services and genuine local issues (Nivola 2002).

But other factors also limit the extent to which decentralized federal systems support learning processes. Learning processes are contingent on the presence of mechanisms that allow adjustments in policies over time, systematic evaluation processes and iterative processes tracking both successes and failures in implementation. The American “laboratories of democracy” framework frequently lacks these features; learning processes are more likely to result from diffusion processes fueled by competition and emulation. Although there is evidence of institutional learning across scales in some policy areas, e.g., state workfare programs developed using waivers from national welfare regulations to become models for national welfare reforms, it is more haphazard and politically charged than the processes implied by learning networks. Furthermore, the “costs” of learning can be high if they generate power shifts and internal conflicts that stakeholders consider unacceptable. This can result in rejection of new resources that require changes in procedures and practices or, at best, a minimalist, partial, limited implementation of new procedures and practices (Leonardi 2003). It can also mean that policy networks acting as learning networks find their efforts to evoke policy change stymied by competing networks able to block the translation of new ideas into new policies (Pemberon 2003).

### **Federal structures and complex conditions**

Often in a celebratory fashion, federalism is touted as a flexible, adaptive, and resilient set of organizational design principles. These features make it an especially appropriate structure for responding to contexts characterized by interdependence, complexity, and uncertainty. While there are institutional lags in this responsiveness, the implicit assumption is that federal structures are more likely to be adaptive than other political designs.

One of the main affirmations of this argument comes not from political theorists but from the corporate sector. Charles Handy (1992), in particular, champions federalism as a set of design principles that suit corporate organizations facing these same types of decision contexts. In a turnabout on the familiar practice of borrowing management principles to “improve” political processes, Handy advocates applying political principles to management issues. Federalism as a way to govern complex organizations addresses what Handy characterizes as “the paradoxes of power and control;” for each, federalism offers a design principle that suits contemporary business and political realities.<sup>8</sup>

For example, organizations “need to make things big by keeping them small,” whether corporations or political units. Size contributes to economies of scale and makes organizations less dependent on a small number of people or outside expertise. But smaller units encourage loyalty

and identity, while often proving more flexible and possibly more innovative. Federalism means not just decentralization with the center acting as a holding company for separate businesses; this arrangement abandons the advantages of scale in which new technologies can be developed and skills can be coordinated. Nor is it divisionalization with separate units grouped under sets of umbrellas, which tends to ignore local contexts and knowledge. And Handy notes federalism is not just a matter of empowering certain leaders; responsibility and leadership authority is spread across decision points throughout the organization. "Centers exist to coordinate, not control (*Ibid*: 62)."

Subsidiarity – although "an ugly and uncomfortable word" – is federalism's most important principle in both the corporate and political sectors as Handy sees it (Handy 1992: 64). He depicts it as a convention where the center governs only with the consent of the governed and argues it is the reverse of empowerment: the center is not giving away power, power resides at the lowest points in the organization and can only be taken away by agreement. The interdependence of units means that there are combinations of power and expertise when and where appropriate but not centralization. As a result, Handy anticipates a matrix, similar to Elazar's early conceptualizations. To Handy, federalism reverses traditional management thinking, assuming that energy and leadership is dispersed rather than centralized.

### **Federal structures and leadership**

Federalism itself requires a different kind of leadership (Bennis 2000): there must be confidence that units can solve their own problems and figure out how to do so; there must be willingness to forego command and control; and there must be understanding and acceptance that groups are capable of self governance. As Handy sees it, federal organizations can be "exhausting to govern since it relies as much on influence, trust, and empathy as on formal power and explicit controls (1992: 60)."

Viewing federal systems from a governance perspective makes us question whether traditional characterizations of leadership in federal systems are sufficient. Effective leadership increasingly will depend on how well public officials anticipate and respond to new decision contexts. A governance perspective draws attention to the leadership tasks now demanded by these new contexts and the normative issues of accountability, legitimacy, and sustainability attendant to governance configurations.

Addressing the governance challenges confronting public officials at every level will require examining their capacity to coordinate, steer, and integrate the multiple actors and processes involved in each issue (Kooiman and VanVliet in Stoker 1998). These cross-sector coordinating, steering, and integrating tasks are likely to demand different leadership skills than those associated with conventional public administration. But



it is not clear that leadership incentives are embedded in governance arrangements in the same way they are in formal institutions. While we expect public officials to seek reelection, to capture resources, to pursue credit-taking strategies, to deflect conflict and controversy and to make other choices that respond to the institutional rules in which they operate, what incentives guide public officials' choices when they move beyond these institutions to steer, coordinate, and integrate networks? Thinking about fuzzy federalism suggests that leadership opportunities and challenges rise from the contingent and uncertain nature of the decision context. There may be more opportunities for leadership but less power to act because power and authority are distributed more widely and in more interdependent ways.

### **Does a governance perspective make a difference in “thinking federally?”**

“Thinking federally” (Elazar 1996) becomes meaningful when federalism is joined to another concept, e.g. policy outcomes (e.g., Radin and Boase 2000), institutional efficiency (Scharpf 1995) or equality. Here the argument is that joining federalism with the concept of governance opens new perspectives and insights on leadership concerns. The rationale for taking governance seriously in thinking federally includes the prospects for more nuanced conceptualization and more comparative analyses of governance strategies in different federal arrangements, a better fit with the realities facing public officials, and greater sensitivity to the normative dimensions of new governance arrangements. It encourages us to see federalism – along with boundaries, territory, place, and the state (Agnew 2002a) – as an analytic concept rather than a “container” for intergovernmental actions. Linking federalism with governance moves away from a state-centric model of federalism; it also suggests a more problematic take on the concepts of boundaries, place, and territory. Finally, a governance perspective also raises the possibilities of governance failure and highlights the tenuous grounds for accountability and sustainability when governance rather than government prevails. In short, a governance perspective on federalism is especially important for the normative and analytical questions it raises.

### **Who governs in governance processes?**

Although governance strategies promise to “get things done” independent of institutional and governmental barriers, this very autonomy conflicts with the territorial grounding of democratic practice and citizenship. Historically (Kubler and Walti 2000), “Both representation and participation are strongly structured by territorial boundaries.” As a result, an emphasis on governance rather than government suggests a potential democratic deficit. It also implies replacing representative democracy with

a participatory democracy where public actions may lack the legitimacy of representational forms.

Both hierarchical and networking governance strategies often promise a “deeper democracy” with more participation and more inclusionary procedures. To fulfill the promise presumes that citizens care about familiar issues, have better information, and more likely to vote more often, and have the time and resources available to participate. Some may, but there also is the prospect of oligarchic private governments skewed to those with resources and organizational capacities rather than deeper democracy. In the absence of devolution of power to sub-state levels, decentralization may actually lead to de-democratization – the shifting of significant public power to private hands at lower levels (Barber 2000: 17). How these new governance arrangements relate to representative government institutions is not always clear.

There is little empirical evidence that new governance mechanisms operate at the expense of elected governments. Indeed, the opposite may be true: that governance mechanisms often work to the advantage of the state, providing new occasions for state influence in associational sectors (Kubler and Walti 2000). Nevertheless, a key element in democratic governance is the recognition of the need to link formal hierarchical governance processes and informal networked arrangements. Allies within the state offer critical resources for networked organizations seeking to redress inequalities (Evans 2001: 300). Creating more integrated webs enhances governance prospects; it also allows assessment of the relative performance of both formal and informal arrangements as well as of areas of conflict, redundancy, and vulnerability. These integrated webs would open up communication, mediation, and negotiation possibilities (Allen and Cars 2000).

Acknowledgment of the significant role of political parties in linking governance and democratic practice is nearly an afterthought in many governance analyses. Parties appear as more important than elections in providing some measure of accountability and democratic control (Blair 2000). Furthermore, many governance arrangements remain strongly linked to representative institutions rather than operating as autonomous and independent systems (Kubler and Walti 2000). But it is possible that the increasing complexity of decision processes may well hamper parties’ integrative capacities over time (Vetter 2000).

Although networks appear to promise more participation outside of governmental channels, they are vulnerable to charges they hamper the development of civic skills and deliberative processes necessary for local democratic practice. Nor do they necessarily enjoy greater legitimacy and trust than traditional representative institutions. Finally, over time, it is possible that networked arrangements could become less participatory and adaptive as well. The issue of “who governs” in governance arrangements remains unanswered.

### **Does governance make a difference?**

There are many examples of governance arrangements addressing problems left unattended to by market forces or government capabilities. One of the most constant questions is whether governance strategies are more effective than government interventions in reducing inequalities. There is little evidence that specific governance modes in themselves – whether decentralization, partnerships, regional alliances – are associated with poverty reduction (Blair 2000; Moore and Putzel 1999).

Civil society organizations can serve specific groups among the poor but political organizations are more likely to – and more capable of – representing the poor effectively in policy decisions (Moore and Putzel 1999; see Appadurai 2000 for a dissenting view). There is empirical support for the argument that more competitive party systems encourage competition for the votes of the poor and are associated with stronger commitments to pro-poor policies (e.g., Blair 2000; Evans 2001). In addition, parties link poor communities with agencies providing services (Evans 2001: 292). As an intermediary organization potentially linking the poor to the state and the market, parties erect an infrastructure that amplifies the voice of poor communities. Weak governance arrangements and fragmented parties provide weak grounds for mobilization of the poor or their allies. In this sense, strengthening governance strategies can increase the odds that governance is associated with poverty reduction.

Some strategies creating new governmental forums appear to increase the voices of marginalized groups, particularly where ethnic minorities are geographically concentrated. In many cases, however, decentralization is not enough: it can encourage competition among existing groups, lead to the elimination of smaller groups, and the emergence of professionalized organizations rather than grassroots voices (Bockmeyer 2003). In short, decentralization may not increase political access and may inhibit collective action.

For governance arrangements to enhance democracy, the non-state and non-market organizations involved would have to mobilize citizens in new organizational forms and open up new arenas for deliberation and negotiation. The expectation is that these new forums would prepare people for other forms of participation as well as empower participants through internal democratic practices. Yet there is significant variation in the extent to which non-governmental organizations themselves exhibit deliberative, consensual processes, internal democracy, inclusiveness, and linkages (Bebbington and Mitlin 1996; Tvedt 1998). But improving governance can benefit the poor: the poor benefit both directly and indirectly from better governance and many pro-poor policies support better governance (Moore and Putzel 1999).

### **Are networks enough?**

Too often, “civil society” is called on as the magic bullet solution to any problem – whether it be developmental, democratic, or devolutionary. Yet “stronger civil society does not necessarily mean better governance” (Bebbington and Mitlin 1996): the complementarity of civil society and government is at the core of good governance. Indeed, the viability and sustainability of non-state actors in governance networks is contingent on governmental legislation enabling and regulating their capacities. Civil society is shaped by the acts of public officials.

Some civil society organizations and private sector participants in networks are oriented to single-issue agendas and many are as bureaucratic as the government institutions they purport to improve on (MS 2000). The “comparative advantage” over government supposedly held by non-governmental organizations due to their flexibility and responsiveness does not always hold up to scrutiny (Tvedt 1998). Both the legitimacy and the representativeness of NGOs and networked arrangements are open to challenge. Looking at partnerships formed to address social exclusion issues, Geddes (2000) found that these partnerships often excluded their supposed beneficiaries, that they often are dominated by the public sector, and that too often they reflect the weakening of national government efforts rather than the emergence of new local governance arrangements.

In addition, there is some concern that networked strategies favor civil society at the expense of the public sector. Advocacy of networked governance strategies and promotion of civil society at the expense of the public sector can exacerbate polarization and power imbalances. It can also shape the future playing field in unanticipated ways. Over time and across communities, governance arrangements will significantly affect the types of interests and organizations that will be active in policy-making as well as the symbols and values seen as legitimate in policy processes. Finally, networks organized around shared purposes may lack the inclusive scope and autonomy provided by more representative arrangements. Rather than promoting flexibility and adaptiveness, they may become privileged and entrenched enclaves.

There also is a tendency to conflate certain types of organizational forms, such as public-private partnerships with network modes of governance. As Lowndes and Skelcher (1998) point out, this obscures the complexity of most multi-organizational activities. It also confuses networks as a mode of social coordination and governance with specific organizational forms.

### **Linking federalism and governance concepts**

Categorizing governance strategies as market, hierarchical, and network strategies clusters similar modes of governance together without conflating them with particular organizational forms. Thus it encourages analyses of

federalism informed by, say, multi-level governance concepts. It permits more systematic and comparative analyses; different governance modes can come into play over time and across issues and types of federal structures.

But lack of precision in the conceptualization of governance processes themselves – especially network strategies – limits our ability to construct more analytic, less descriptive, accounts of governance arrangements and federal structures. Better specification of the differences between networks and other forms of collective action is needed. Measurement of management in networks remains elusive (but see Agranoff 2003a, 2003b). As a result, there is a weak base of systematic, persuasive evidence that governance arrangements are effective, efficient, and equitable in producing desired outcomes. Hooghe and Marks (2003) suggest that the goals of Type I and Type II governance arrangements differ significantly but we have little empirical research to support this claim. Nor can we demonstrate that some governance arrangements offer prospects for more democratic, responsive practices or will be less accountable than others. And to the point, we require empirical research on the contention here that governance processes in federal systems are distinctive from non-federal systems.

### **“Getting it right”**

A governance perspective strengthens our understanding of federalism in several ways.

It brings a more actor-oriented viewpoint into focus, along with a more extensive, less state-centric scope of analysis. Although this more extensive reach is at the cost of elegance and parsimony, it is more likely to ensure that our analyses “get it right” and present a more useful diagnosis of governance dilemmas for policy-makers and practitioners.

### **When governance fails**

Too little attention is given to the downside of governance – the potential for governance failures. There are many grounds for governance failures. One of the simplest and most devastating is “governance gaps” (Potapchuck *et al.* 1999): while governance arrangements and strategies are oriented to specific problems, many important issues spill over boundaries of every sort. The failure to deal with these governance gaps can result in increasingly significant and troubling problems that trump any governance successes.

Governance failures can be prompted by network characteristics. The internal cohesion and adaptability of individual organizations in the network suffers if there are significant differences in time scales and horizons. And if there is a low level of interdependence among stakeholders, networks will be unstable and lack the trust necessary to operate effectively. Weak network links can also stem from and reflect tensions with and within civil society; an inability to manage social conflicts can thwart net-

worked arrangements (Stoker 1998: 24). Similarly, competition and lack of coordination in the network can compound problems of steering (Rhodes 1996: 664). Failure of network leadership is also a familiar constraint.

Governance failures also may occur around implementation issues. Failure is likely if there is an oversimplification of the conditions in which networks are operating as well as if knowledge about salient issues, e.g., global economy, climate change, is incorrect or insufficient. *Ad hoc* governance arrangements may provide short-term capacities for problem-solving but flawed design features can threaten their sustainability over time. And even though new policy networks might emerge, competing networks can resist their control and hamper their abilities to translate new ideas into new policies (Pemberton 2003). Even though the discourse may change, institutions often lag in responding to new conditions; path dependency can stall or thwart transitions to new governance arrangements.

Governance suffers from a legitimization deficit: networks lack strong normative underpinnings in public opinion as well as in the media; citizens appear to prefer services delivered by elected officials. This suggests governance failures may also occur if there is insufficient capacity to manage the repercussions of devolved decisions made by networks. At the most fundamental level, the exclusiveness of networks driven by the shared purposes and self-interest of members raises profound concerns about accountability relative to representative structures. The latter can be held accountable to wider concerns about the public interest through elections but networks lack such measures. Looking beyond government to governance arrangements also may mean there is no accountability to specific institutions; this implies a divorce between governance and the normative codes used to justify and explain government (Stoker 1998: 19). A consequent erosion of accountability occurs when it is not clear who is accountable or what powers might hold government agencies to account when they are part of governance arrangements. Scapegoating and blame avoidance is a real prospect when responsibilities are blurred. Ensuring the potential transparency of governance processes is an unresolved issue as is the prospect of performance benchmarks for governance arrangements.

Governance processes can become outdated. Most often, this occurs when the governance processes no longer fit the scale of problems at hand. Lack of fit can also occur if significant stakeholders do not have effective roles in decision processes. Or the decision processes themselves lack definition, transparency, and accountability (OECD 2000). Crafting sustainable governance processes entails building in capacities for evolution, learning, and adaptation.

### **Can good governance be designed?**

These prospective hazards lead us to ask if deliberate design of governance arrangements might circumvent these potential conditions for governance

failure. Several design principles are available for assessing the adequacy, viability, and potential effectiveness of various governance arrangements. There is considerable overlap, and perhaps consensus, on many of the design principles listed by OECD, the European Union, and other analysts. These favor governance processes that include: coherency, openness, effectiveness, coordination, transparency, flexibility, accountability, holism, particularity, and participation (OECD 2000; UNDP 1997; EU 2001). More coherent governance processes, for example, are more intelligible to the electorate as are more transparent ones (OECD 2000; EU 2001). Networked arrangements are especially prone to the charge that nobody knows “who does what.” This hampers accountability as well as impeding trust and cooperation. Flexibility entails reliability, robustness, and sensitivity to motivational complexity, and variability to encourage experimentation (Stoker 1998: 26). Applying these governance principles supports other goals including proportionality and subsidiarity (EU 2001), and sustainability. In designing governance strategies, there is also a concern for the stewardship of federalism (Peirce 2003) – preserving the integrity of the principles and practices of federalism as it accommodates governance dilemmas.

### **Which federalism? Which governance?**

In contrast to discussions of revenue and taxation systems and service-delivery mechanisms, governance issues are less visible in federalism discussions. This is not surprising, given their intangible nature and seeming lack of immediacy. Few public officials will be blamed, much less voted out of office, for governance failures. But the argument here is that effective leadership is increasingly contingent on understanding governance dilemmas and the ways in which federal structures structure the possible responses. Therefore, scholars and public intellectuals engaged in the issues of the day – which increasingly *are* governance issues – bear a special responsibility for mapping out this new leadership terrain.

### **Notes**

- 1 Fuzzy logic evolved as a way to deal with imprecise and uncertain information in complex, adaptive systems; it features clusters or groupings where the boundaries are not sharply defined – that is, they are fuzzy. Many social science problems fit this characterization; Ragin (2000) argues that these features – fuzzy boundaries, imprecise information – necessarily mean reliance on the use of fuzzy logic and contingent causality rather than the “crisp” assumptions of linear causality underlying more positivistic social science research strategies.
- 2 This section draws on Stone 1989; Stoker 1998; Potapchuck *et al.* 1999; Rhodes 1996; Jessop 1998; see discussion of earlier version in Clarke 2002.
- 3 The choice of governance strategies influences who is likely to be included or excluded in new governance arrangements as well as which policy instruments will be available. Thus governance strategies are not value neutral: they are shaped by and sustain social and cultural values and speak directly to issues of

social cohesion and social exclusion. From a pragmatic viewpoint, the important question is under what conditions do different governance strategies work effectively? (Rhodes 1996) And for which purposes?

- 4 For examples, see [www.socialplatform.org](http://www.socialplatform.org) and [www.feantsa.org](http://www.feantsa.org).
- 5 The Pacific Northwest is more interdependent with Canada than most other areas of the US: over 80 percent of the region's gas supply comes from Canada (PNWER 2001).
- 6 For example, in February 2001, Canada established an Office of Critical Infrastructure Protection and Emergency Preparedness, under the Minister of Defence, to protect critical infrastructure and to ensure national civil emergency preparedness.
- 7 On 12 December 2001 US and Canadian officials signed the "Homeland Security US and Canada: An Efficient, Secure, and Smart Border" declaration emphasizing the importance of public security and economic security.
- 8 Handy lists these as "making things big to keep them small, to encourage autonomy but within bounds; to combine variety and shared purpose, individuality and partnership, local and global, tribal region and nation state, or nation state and regional bloc (1992: 60)."



# 4

## Social Forces, Space and Boundaries

*Ann O'M. Bowman*

### **Introduction: the case of Texas**

What is it about Texas? The state's name conjures up sartorial images of boots, jeans, and cowboy hats. Food-wise, mention Texas and one's thoughts turn to barbeque and fajitas. It is a place where the people are friendly and courteous toward others, but only to a point. Texans do not give up easily, or to use Texan terminology: they stick to their guns – the siege at the Alamo in 1836 immediately comes to mind. The common image of the Lone Star state is that of wide-open spaces, oil derricks, and pick up trucks, although the state contains three of the nation's ten largest cities (Houston, Dallas, and San Antonio). It is a place where opportunity abounds, as demonstrated by its sustained economic growth over the past several decades. The popular slogan, "Don't mess with Texas," conveys bravado unequalled in other states.

Texans wear their statehood proudly, as one seventh-generation Texan commented, "Being a native Texan is an integral part of my identity..." (Axtman 2003). The state's history has helped mold its identity. Texas was an independent republic for a decade after it won independence from Mexico and that, along with the agreement under which it achieved US statehood, makes it unique. Of the land claimed by Texas when it joined the Union in 1845 (designated by the shaded area in Figure 4.1), about one-third was ceded to the US in exchange for \$10 million as part of the Compromise of 1850.<sup>1</sup> These disputed lands later became parts of the states of New Mexico, Oklahoma, Kansas, Colorado, and Wyoming (Lone Star Junction 1996).

Four different proposals for carving up the Texas territory received serious consideration in the US Congress. (See Figure 4.2) The Benton Plan cut the northern and western sections from Texas and would have split the remaining area into two states. The Bell Plan sliced off the northern portion and would have divided Texas into three states. An alternative proposed by Henry Clay would take less land from Texas than the Benton Plan

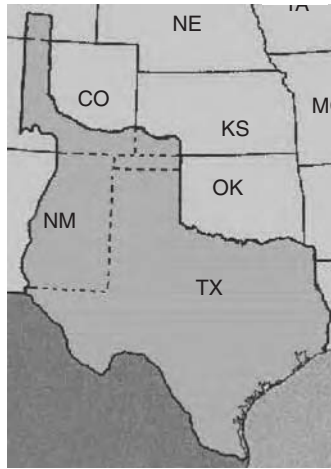


Figure 4.1 The territory of Texas as it entered the union, 1845

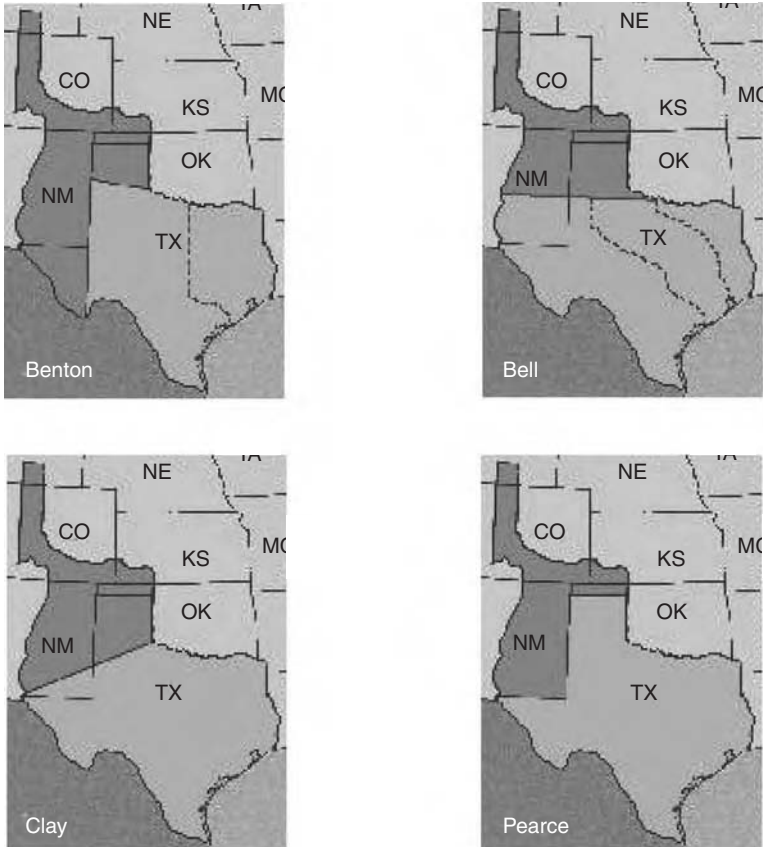
Source: Texas History Timeline: Statehood and Beyond, 25 November 1850, [www.lsjunction.com/events/comp1850.html](http://www.lsjunction.com/events/comp1850.html)

would but more than the Bell Plan; however, it would have left the remaining state intact. The plan adopted by Congress, the Pearce Plan, was similar to Clay's in that Texas was to remain a single state, but the boundaries were trimmed to essentially those that exist today.

Had Congress subdivided Texas into two states, essentially an east and a west as proposed in the Benton Plan, the Texas exceptionalism discussed above would have been less likely to develop. Congressional approval of Bell's three state plan that used rivers as borders would have created more homogeneous entities in terms of terrain but "Texas" would have essentially disappeared. The expansive size and extensive diversity of Texas, created by the Compromise of 1850, has worked to the state's political and economic advantage.<sup>2</sup>

Texans' level of state pride may be more pronounced than in other states, but only as a matter of degree. Each US state has its own history and culture; each has constitutions and political institutions that reflect historical and cultural influences. As Gimpel and Schuknecht (2003: 10) note, "The identification of the citizenry with their states remains sufficiently strong at the beginning of the twenty-first century that people in otherwise similar adjacent states still proudly identify themselves as from one state or the other." But it is more than simply a feeling. The boundaries that separate space into discrete jurisdictions have legal meaning, and they also carry social and political consequences.

Borders within states function similarly as communities develop and maintain their own identities. An example from the early 1990s underscores this



**Figure 4.2** Proposals for dividing Texas

Source: Texas History Timeline: Statehood and Beyond, 25 November 1850, [www.lsjunction.com/events/comp1850.html](http://www.lsjunction.com/events/comp1850.html)

point. Because of the way the Pearce Plan drew the boundaries for Texas, geopolitical features that resemble panhandles were created in both Texas and Oklahoma. In terms of physical distance, panhandle residents are located a long way from the governmental centers of their respective states. The psychic distance may be great as well. In 1992, a group of renegade Kansas counties sought to capitalize on the relative geographic isolation of the Texas and Oklahoma panhandle residents. Voters in nine southwestern Kansas counties bordering Oklahoma, unhappy with their limited political influence in the state capitol in Topeka, had approved ballot measures calling for secession from Kansas (The State 1992). They figured that nearby panhandle residents might be willing to join their effort to create a new state, one that was centered on their region. Although the secessionist sentiment was ultimately more sym-

bolic than substantive, it did force Kansas officials to take actions to mollify the separatists. Still, in that part of Kansas, as well as in the panhandle regions of Texas, Oklahoma, and other states, distance can attenuate the sense of belonging to the state.<sup>3</sup> And it may stimulate a stronger, subregional identity.

This discussion of Texas and Kansas highlights the way in which social forces, space, and boundaries function in the US federal system. As federalism scholar Daniel Elazar (1994a: 3) once said, "Territorial boundaries, whether national borders or household property lines, sort people out in space so as to minimize conflict and aggression and organize competition and cooperation among people." Federalism, as a structure, is often extolled for its ability to achieve national unity while promoting subnational diversity.

The themes of this introductory discussion are developed in the remainder of the chapter. First, the focus shifts to a more conceptual consideration of space, place, and borders, which sets the stage for an examination of the founding of the US and the persistence of sectionalism. After that, a constitutionally-created mechanism for overcoming state boundaries and fostering regional cooperation, the interstate compact, is addressed. From interstate compacts, the chapter moves to an examination of an alternative, non-spatial governmental structure, more specifically, the case of Belgium and the representation of language communities. In the conclusion, the lessons of social forces, space, and boundaries are reconsidered.

## Space, places, and borders

The distinction between "space," a more general term, and "place," a more particular one, is worth considering. According to political geographer John Agnew (2002b), space is an area in which an organization such as a nation-state functions. A map image and narratives solidify the spatial meaning in public consciousness. Thus we refer to the US as stretching from the Atlantic to the Pacific Ocean, reaching from Canada on the north to Mexico on the south. Additionally, a repository of nation-sustaining stories of heroes and critical events has taken on near-epic proportions. We conceive of an American national identity that connects individuals located at distant points across the country and at different periods of time. On the other hand, "place represents the encounter of people with other people and things in space" (Agnew 2002b: 5). Place is, in effect, home. The US then, is a large space comprised of smaller communities or places. A territorially-based federal system of government is of great value in both managing space and in nurturing place.<sup>4</sup>

Space in a physical sense – the extent of the land area or the features of the landscape – is a fundamental aspect of not only nation-states but of local jurisdictions also. Consider two cities of relatively similar population size, Austin, Texas (656,562) and Boston, Massachusetts (589,141). These

cities vary on numerous dimensions, but one fundamental difference is their territorial space. Austin's city limits encompass 258.4 square miles (of which the actual land area is 251.5 square miles); Boston's territorial limits are 87.6 square miles (48.4 in land, 41.2 in water). Boston is hemmed in by incorporated jurisdictions and a harbor while Austin has been able to extend its reach through annexation of adjacent unincorporated land. In fact, Boston would have a more circumscribed land area had it not engaged in extensive land filling along its waterfront during the 19<sup>th</sup> century. The population density of the two cities varies accordingly: Boston's density is 12,172 people per square mile compared to Austin's 2,611 people per square mile. The different spatial sizes signify different land development patterns and divergent paths to future growth and development.

Jurisdictional territories, like those of Austin and Boston, are bounded space. Boundaries, or borders, fix the physical limits of a jurisdiction, and denote the range of jurisdictional authority. But boundaries are more than this. "Bounded territoriality is one critical thread in sewing together potentially disparate persons into a single entity, a border that is also a social and political marker indicating commonality" (Jacobson 2002: 9–10). Naturally-occurring features such as rivers and mountain ranges tend to be effective boundaries due to their permanence. Furthermore, population groups tend to separate along these features making it less likely that the border will bisect like cultural groups. Still, borders are often superimposed on the existing cultural landscape, and consequently affect human settlement patterns (Timothy 2001).

The creation of West Virginia offers an interesting example of a boundary growing out of both the extant cultural landscape and settlement patterns. Originally, the area was the portion of Virginia located west of the Blue Ridge Mountains. Not only was it physically distant from the eastern heart of the state, it had a different population base: immigrants from Pennsylvania. Politically, the western part of Virginia had little clout in a system dominated by plantation owners from the plains and tidewater regions. Indicative of the political imbalance, the state constitution drafted during the 1850s institutionalized the under-representation of western counties in the state legislature. At the onset of the Civil War and the secession of Virginia from the Union, disgruntled residents of the western counties in turn seceded from the state, establishing a new governmental structure based in the town of Wheeling (West Virginia Division of Culture and History 2006). Leaders in the newly-formed government sought the creation of the state of West Virginia, which was admitted to the Union in 1863.

The process for the creation and entry of new states into the Union is set out in Article IV, Section 3 of the US Constitution. It provides that:

New States may be admitted by the Congress into this Union; but no new State shall be formed or erected within the Jurisdiction of any other

State; nor any State be formed by the Junction of two or more States, without the Consent of the Legislatures of the States concerned as well as of the Congress.

In the case of West Virginia, the consent of the Virginia legislature was effectively moot given that the state had already seceded from the Union.<sup>5</sup>

Political boundaries have other functions besides defining the territory of a jurisdiction. Borders exert "significant influences on the economic and sociological aspects of the human experience" (Timothy 2001: 3). This is certainly the case when borders demarcate the line between two nations, and it is also the case with regard to borders between two US states. When the Daimler-Chrysler corporation sought a site for its new manufacturing facility in 2002, it identified a section of the south Atlantic coast as the preferred locale (DuPlessis 2002). The two finalist sites had many of the same characteristics such as a deepwater port, interstate highway frontage, and hundreds of developable acres, but one was located in Georgia, the other in South Carolina. Although the objective features of the sites were nearly interchangeable, their locations on opposite sides of a state line made the sites qualitatively different. This specific example of an industrial location decision makes the larger point: tax rates differ, policies diverge, and service packages change from one side of the boundary to the other.

Boundaries that are established at a lower scale, in localities such as a city or county, function similarly to define the legal limits of the jurisdictions. The US Constitution does not speak to local jurisdictions; state

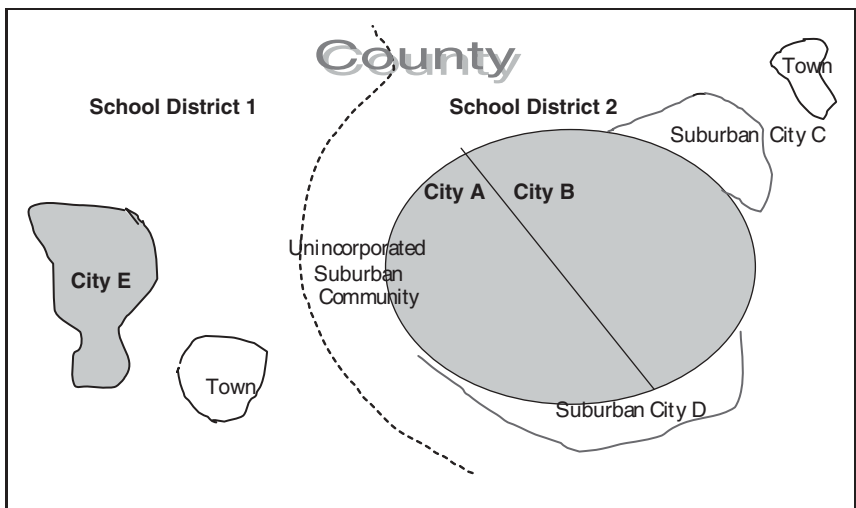


Figure 4.3 Local government territories: 1 county, 5 cities, 2 school districts, 2 towns

constitutions devise their own rules for making places out of territorial space. Although easily traversed, local boundaries carry fiscal and substantive significance. Local boundaries are different from those of the states because multiple local jurisdictions may share the same territory. That is, a typical city or town lies within the confines of a county, and in some, the legal limits extend into two counties. School district boundaries may be coterminous with a city or county, or they may split a city or county into different districts. (See the hypothetical county depicted in Figure 4.3). Special districts add another layer of boundaries, subdividing and joining cities, counties, and school districts.<sup>6</sup> In a typical metropolitan area, the boundary situation is complex with large numbers of borders that may cross-cut or overlap jurisdictions. The next section puts the issue of space in historical context.

### **The founding: space, colonies, and states**

It has become commonplace to consider the United States as a single entity but such thinking defies historical realities. As Forrest McDonald (2000: 7–8) put it, “the colonies did not have a single hypothetical compact with the king of Great Britain; they had thirteen real compacts in the form of charters that gave them existence as political societies.” Furthermore, the American colonies had limited contact with each other until the French lost their power base in North America and the British tightened their grip on the region in the 1760s. As the revolt against British rule proceeded, the task that confronted the Continental Congress in 1777 was “the difficulty of combining in one general system...a continent divided into so many sovereign and independent communities” (Hendrickson 2003: ix).

Colonists’ primary loyalty was to the place in which they lived and the colony in which it was located. By the time of the revolution, colonist identity with the region was growing as feelings of solidarity and mutual interest emerged among similarly-situated states. Much of the incipient regionalism was economically motivated. A planter in South Carolina was likely to have much in common with planters in other southern states, certainly more connection to them than to a merchant in New York or a Massachusetts fisherman. However, even within a particular region, rivalries developed between states. In the South, an “upper” versus “lower” South pattern developed, most significantly when the Virginia gentry began to question the continued importation of slaves while Georgia and South Carolina vigorously defended the practice. A state like New Jersey, originally settled as two separate colonies, East and West Jersey (reunited in 1702) was dominated economically and overshadowed politically by its wealthier, larger, and more powerful neighbors, New York and Pennsylvania (Taylor 2001). But the exigencies of revolution forced the individual states to put aside their particular rivalries and unite.

The preceding assessment underscores an important point about the American founding: the United States really was not united states. The Articles of Confederation had created a “firm league of friendship” among the former colonies because that was the extent of the colonies’ desire for unification. The subsequent demise of the Articles rekindled the debate over the relationship of states to each other and to a central government. Although little support existed for treating the 13 states as separate nations, the idea of multiple confederacies surfaced and was debated. In *Federalist 13*, Alexander Hamilton (1787/1937: 77) wrote of the plan, “The ideas of men who speculate upon the dismemberment of the empire seem generally turned toward confederacies – one consisting of the four Northern, another of the four Middle, and a third of the five Southern States.” In other words, the 13 states might be too dissimilar to coalesce into a single entity, but regionally-connected subsets of states or sections were sufficiently similar to unite. The power of the multi-state sections in early America had been demonstrated in a most significant way. After all, “the political coalition that led the march to independence was an alliance between New England, led by Massachusetts, and the southern states, led by Virginia; it joined the antipodes against the middle colonies” (Hendrickson 2003: 177).

Growing sectionalism was a real concern in many quarters, stoking a fear that European nations would exploit a divided America. The three-part division – northern (or eastern), middle, and southern – was a common way to think about the states, but in some disputes a “two against one” pattern emerged, as in the example in the preceding paragraph. The states combined and recombined in different ways, as time passed and issues changed. The four-state southern cluster – Virginia, North Carolina, South Carolina, Georgia – stayed a fairly consistent subset throughout the pre- and post-revolution period, similar in economic base and united in support of slavery. Among the four southern states, the perception was frequently “us versus the rest,” that is, the South and its values against the other nine states. Similarly, the New England states developed a sense of unity on issues involving access to fisheries, a topic that was of much less significance in the other states. Although the three-region view of the US in the early years is generally accurate, the groupings fluctuated somewhat in response to issues and conditions.

After the Constitution was ratified and the 13 states became a single nation, not three confederacies, the task of nation building was formidable. The process for expanding the new nation’s boundaries was spelled out in the Northwest Ordinance of 1787, which created the framework for territorial government and defined the process through which most states would join the Union. Once a territory reached a population of 60,000, it qualified for admission to the Union as a state, equal in status to existing states. The legal symmetry of states, regardless of a state’s



date of entry into the Union, is an important feature of American federalism. David Jacobson (2002) argues that the ordinance, more than the Constitution at that time, reflects the *raison d'être* and social vision of America. The ordinance “outlawed slavery in the Northwest Territory; guaranteed freedom of religion and other civil liberties; promised fair treatment of resident Native Americans; and provided for education (Jacobson 2002: 91). The statehood process it set out became the model through which 31 of the 50 states would be admitted to the Union. As illustrated in the next section, the issue of how the states fit together and formed regions remained relevant.

### **Large spaces: sectionalism in the US**

Frederick Jackson Turner (1932), the historian who posited the frontier hypothesis as the explanation for the development of the United States, offered a related argument about the political importance of sections or regions. Sections, as defined by Turner, are larger geographic areas than states, but smaller than the broad designations of North and South. For example, the eastern portion of the South is composed of a seaboard region (the Atlantic plains) as well as an upcountry, or Piedmont. The more western part of the South is the Gulf Plains, thus creating at a minimum, a three-section South. Turner (1932: 183) argues that “sections are more important than states in shaping the underlying forces of American history.” From his vantage point a half-century after the Civil War, political conflict between the sections of the country remained a potentially disruptive force in American politics. According to Turner, the geographical features and economic interests of the various sections made them inherently rivalrous.<sup>7</sup> Politics adhered to these sectional cleavages as demonstrated in congressional voting patterns and presidential election results. Turner (1932: 37) went so far as to refer to the US as “a federation of sections.” In comparing the US to Europe, he argued that “a common language, law and institutions, absence of sectional concentration of religions and races, absence of historical hatreds, have helped to prevent America from splitting apart and falling into European conditions” (Turner 1932: 205).

With politics adhering to multi-state sections, contentious issues could severely stress the growing bonds of nationalism. National unity was maintained by (1) the party system which, even though it was susceptible to sectional demands (as the Civil War showed), tended “to draw sections together toward national adjustments by compromise and bargain” in Congress and, by (2) regional heterogeneity, which prevented sections from developing completely uniform positions and lock-step outlooks (Turner 1932: 205). Still, to Turner, the US was a nation ever vulnerable to sectional conflict and its consequences.

These themes were echoed to some degree by V.O. Key, Jr., an astute observer of American politics, who once said:

Sectionalism, or conflict along territorial lines, may threaten national unity as sectional cohesion tightens and the lines of cleavage between sections deepen. The way of life of a region may lead its citizens to look upon the "outsider" as an "alien" – a feeling not unlike that of the people of one nation toward those of another. Territorial differentiation and conflict in extreme form may pose for the politician the problem of manufacturing a formula for the maintenance of national unity (Key 1964: 233).

Key, who focused much of his research on the South, was similar to Turner in his argument about the role played by geography and economics in creating sectional politics. He defined sectional politics as "a sharing of interest and attitudes by people of all sorts in a major geographical region against a similar clustering of interests and attitudes of the people of another region" (1964: 232).

The impact of economics and geography on politics is extended by Bensel (1984: 22) who contends that "Since 1880, one pole of the sectional axis around which American politics has revolved has been the industrial and commercial-seaport cities of the Northeast and Midwest. At the opposite pole have been the interior distribution centers of the plantation South." The economic imperatives of the industrial core are contradictory to those of the agrarian periphery and, in Bensel's view, the resultant conflict has structured the political system. To explore the argument about sectionalism, he used a non-governmental spatial section: a trade area. Growing out of central place theory, a trade area has two interdependent parts: an urban center and a surrounding hinterland. Trade areas have an advantage over states as the building blocks for regional analysis because their boundaries evolve over time, changing to reflect population growth and economic shifts. For example, in 1885, there were 33 trade areas in the US, by 1955, the number had increased to 63. However, by the 1965–75 period, the number of trade areas had declined to 50. Furthermore, trade areas are not restricted by the fixed boundaries imposed by state borders.

Consider the area bordering the Gulf of Mexico. In 1885, two trading areas defined the expansive region, one centered around Savannah, the other around New Orleans. By the 1965–75 period, substantial increases in population and robust economic growth had spawned seven trade areas with centers in Miami, Tampa, Jacksonville, Mobile, New Orleans, Houston, and San Antonio. Note that Savannah had lost its regional prominence as Jacksonville and Atlanta extended their economic reaches over time (northward and eastward, respectively). The consolidation of older trade areas as new centers emerge reflects changing economic conditions.

To test for sectional stress, Bensel examined roll call voting in the US House of Representatives in ten different Congresses from 1880 to 1980, aggregated to reflect trading area boundaries at the various points in time. He found high levels of sectional stress on nearly half of the competitive roll calls, with extremely high stress on 15 percent of them. One example of an extremely high stress issue was the proposal in 1959 to extend the life of the US Civil Rights Commission (Bensel 1984: 55). Although sectional stress tended to decline after the mid-1940s, the bipolar structure to American politics persisted. Aligned on one side is an urban industrial core composed of trade areas based primarily in Boston, Chicago, New York, Philadelphia, and San Francisco; on the other is an agrarian periphery clustered in Atlanta, Dallas, Denver, Memphis, and Richmond.

Bensel's non-state way of thinking about regions raises interesting questions about the utility of state lines. There are many regional configurations that join, subdivide, and in various ways, reconfigure the states. The creation of federal reserve district boundaries in 1912 and 1913 is an official example of non-state regionalism. "The nation's leading cities competed for the designation as federal reserve district headquarters, and those that won had districts drawn to reflect their spheres of influence, regardless of state lines" (Elazar 1994a: 141). A more fanciful recombination of places into larger regional groupings is Joel Garreau's (1981) "nine nations of North America." He contends that state boundaries are simply irrelevant; that, for example, Colorado divides into meaningful eastern and western portions, that California has a north-south divide. Garreau identifies nine distinctive regions on the continent:

Each has its capital and its distinctive web of power and influence...Each has a peculiar economy; each commands a certain emotional allegiance from its citizens. These nations look different, feel different, and sound different from one another, and few of their boundaries match the political lines drawn on current maps. Some are clearly divided topographically by mountains, deserts, and rivers. Others are separated by architecture, music, language, and ways of making a living. Each nation has its own list of desires...Each has a different future...Most important, each nation has a distinct prism through which it views the world (1981: 1-2).

Garreau's "nations" (or what Turner would have labeled "sections") include some standard designations, e.g., a southern nation labeled "Dixie," with Atlanta as its capital, a "New England," with its capital of Boston, and the "Foundry" with Detroit as its capital. However, some of the areas are at odds with common conceptions including the "Breadbasket," which stretches north from southern Texas into Canada and as far east as rural areas of the Midwest. Other unusual regions are "Ecotopia" (the

capital is San Francisco), which runs along the Pacific Coast from Santa Barbara into Alaska, and the "Empty Quarter," which includes much of the southwest, the Rocky Mountain area, and a large portion of Canada. State lines, which Garreau (1981: 1) considers the product of "historical accidents and surveyors' mistakes" are wiped out. For instance, in his configuration, the northern Virginia area is separated from the rest of the state which lies firmly in Dixie, and is included in the Foundry.<sup>8</sup>

Garreau's formulations are not derived from an elegant theoretical model nor are they subjected to a sophisticated statistical test. Instead they are the product of a journalist's efforts to turn space into place. And they raise provocative questions of the utility of extant state borders, at least in an extra-legal sense. In the next section, the same issue is explored but in a very different manifestation.

### **An exercise in border spanning: interstate compacts**

The US Constitution contains a provision (Article I, Section 10) that allows states to enter into interstate compacts, which are formal agreements or contracts that allow them to pursue a shared agenda or tackle a common problem. Often regional in design, compacts provide economies of scale by, in effect, allowing a state to stretch its boundaries and its influence. Once a state ratifies a compact, its provisions have legal superiority, that is, they take precedence over conflicting state laws. The compact itself sets up the rules for state compliance with and withdrawal from the compact as well as amendments to and termination of it. More than 200 interstate compacts were in existence by 2003 and they ranged in type from simple border-defining compacts between two states to innovative policy compacts in which membership is open to all states. On average, a state belonged to 25.4 interstate compacts (Bowman 2004a).

Compacts are particularly useful in situations with cross-border consequences. Take, for instance, a case in which the border between two states is a shared resource such as a river. Similar to the classic common pool resource dynamic, interdependence exists as each state's use of the river (e.g., water consumption, water quality) affects the other states' use. In a series of continuing encounters, each state has the potential to be a renegade actor and each is vulnerable to the consequences of other states' actions. Assuming that each state understands the long-term implications of the interdependence, each should work with the others to design a solution acceptable to all of them. Thus the border has been transformed from a feature that divides states to a mechanism for bringing states together.

Bringing states together does not necessarily result in harmonious resolution of differences, however. Alabama, Florida, and Georgia share the Apalachicola-Chattahoochee-Flint river system and have repeatedly clashed over thorny issues such as water levels and allocation formulas (Bowman

2004a). Alabama's interest is in water for hydropower and shipping, Georgia wants water to sustain growth in the Atlanta metropolitan area, and downstream Florida's primary concern is the protection of fish and wildlife and the seafood industry. Thus each state's preferred solution is at odds with another state's preference. An interstate compact was the institution created in 1997 to provide a mechanism for continued negotiations among the states. Each state wanted to settle the conflict but on terms that were, if not preferential, at least acceptable to it and each state held a potential veto over any agreement reached by the other two states. As of 2006, agreement among the states had not been achieved, but the negotiations continued within the interstate compact framework.

Although most interstate compacts are regional in design, a growing number of them allow state participation from outside the region. The Low Level Radioactive Waste Act of 1980, which requires each state to make arrangements for the disposal of certain types of nuclear waste generated within its borders, has produced some non-regional compacts. For instance, the Texas Compact joins three non-contiguous states: Texas, Vermont, and Maine, while the four-state Southwestern Compact includes North Dakota and South Dakota among its members.

National compacts, those in which participation is open to all 50 states, provide an alternative to federal legislation (and pre-emption). As of 2003, approximately 18.8 percent of the compacts that were in force allowed the participation of all states. Typically, national compacts establish uniform rules and regulations for an activity, and facilitate the exchange of information across states. Other national compacts go further in creating reciprocal agreements that, for the specific policy addressed by the compact, have the effect of obliterating state lines among participating states. This type of compact does more than simply harmonize policies and procedures; it expands a state's reach across its borders into other states while opening its own borders to other participating states. If widely embraced, the interstate compact provision of the US constitution has the potential to transform state lines.

### **Beyond boundaries and space: non-territorial aspects of federalism**

The discussion in this chapter has emphasized the territorial aspects of the US federal system, more specifically, the interaction of social forces and space in the creation of boundaries. But a federal system can be organized in ways that are non-territorial. Although the US is not a relevant example, Belgium, a country of ten million people, offers a case in point. It is divided into three spatial regions – Flemish (Flanders, located in northern Belgium), Walloon (Wallonia, located in southern Belgium), and Brussels (the capital region located near the center of the country) – and ten provinces. In addition, Belgium has three ethnolinguistic-based communities: Dutch-speaking,

French-speaking, and German-speaking (Murphy 1995). The Belgian Constitution assigns different sets of powers and responsibilities to the regions (e.g., environmental protection and regional development) and to the language communities (e.g., culture and education). The non-territorial representation of language groups in government is a structural response to the ethnic conflict that had characterized the country since its founding.

Although Belgium is linguistically diverse, the different language groups are not widely dispersed throughout the country. In the case of two of the spatial regions, there is correspondence between them and the relevant language community (Flemish and the Dutch-speaking community, Walloon and the French-speaking community). Brussels is comprised of both language groups (although French speakers are a large majority), therefore in the capital region, Dutch-speaking residents and French-speaking residents are members of their respective language communities.<sup>9</sup> The German-speaking community, located on Belgium's eastern border, exercises the powers of a language-based community but does not have territorial competence. (The Walloon region has authority in territorial matters for the German-speaking community.) Thus in Belgium, there is "incomplete congruence between Regional and Community borders: Brussels is a Region but not a Community, and the German-speakers have been recognized as a Community but not as a Region" (Swenden 2003: 7). The number of Dutch speakers in Brussels is a relatively small share of Dutch-speaking Belgians and even before the constitutional reforms of the early 1990s, the Belgian Parliament approved the merger of the Dutch community council and the Flemish regional council into a single entity. The French community and the Walloon region have maintained their separate governmental institutions. And although conflict continues over the important issue of power sharing between the central government and the regions, the Belgian structure appears to be working. Its unique blend of territorial and non-territorial structures may be complex, but in a nation that is essentially a bicomunal polity, it may be the best option (Murphy 1995). In the words of Liesbet Hooghe (2003: 76) "Federalism is Belgium's best chance for survival."

## Conclusion

Social forces, space, and boundaries matter. The manner in which space is subdivided to create polities has a powerful impact on the way the political system operates. The creation of West Virginia out of the state of Virginia provides an illustration of how social forces interact with boundaries and, if conditions are right, how they can effect a systemic shift. However, the failure of southwestern Kansas counties to bring about a similar shift 130 years later shows the difficulty in altering extant borders. But it raises an interesting, if whimsical, set of questions: If we were drawing state boundaries today, how different would they be? How would space be transformed into place? And on what principles would borders be redesigned?

Furthermore, is territory a sufficient means for organizing political life in an increasingly multi-ethnic society (Smith 1995)? Is there a need to accommodate non-territorial interests? And if so, which social forces would prevail to elevate certain interests to the level of representational?

The questions raised in the preceding paragraph are intended to be more provocative than prophetic. Over the years, the US federal system has been remarkably adept at accommodating crisis and change. In fact, one of its distinguishing features is its ability to adapt to new circumstances and conditions. From 13 former colonies stretching along the eastern seaboard to 50 states encompassing a vast land mass (including two states that are non-contiguous), the US federal experience provides many lessons. Although workable governmental structures are strongly influenced by history and tradition, issues of social forces, space, and boundaries are ubiquitous. The US case is certainly worthy of reflection, and in some instances, emulation.

## Notes

- 1 The Compromise of 1850 dealt with the expansion and preservation of the US. The fundamental issue was the extension of slavery into new territories and whether the (eventual) states would enter the Union as free or slave states.
- 2 One of the features of the legislation admitting Texas to the union was a provision that would have allowed the creation of up to four additional states out of Texas, a consequence of the roiling political debate of the time over the extension (or prohibition) of slavery in new states.
- 3 In Michigan's Upper Peninsula, a land mass that is separated from the rest of the state by a body of water, the Straits of Mackinac, there are occasional calls to secede from Michigan to form a new state, Superior.
- 4 Federalism can be non-territorial also. The key is "securing the cultural rights of geographically scattered ethnic groups by providing non-territorial-based institutional supports in combination with a non-territorial form of political representation" (Smith 1995: 6). This topic is addressed later in the chapter.
- 5 The decision of the US Supreme Court in *Texas v. White* (74 US 700) put an end to the state secession issue. In its ruling the Court referred to the "perpetuity and indissolubility of the Union," and stated that despite its declaration of secession, Texas had remained a US state.
- 6 Many Midwestern states also have 36 square mile townships (created as a result of surveys done in conjunction with the Northwest Ordinance) as viable jurisdictional units, which can complicate the growth of cities.
- 7 Turner's assessment of sectional rivalry is similar to what many others have said about the states themselves. See Dye (1990) and Kenyon and Kincaid (1991).
- 8 Garreau acknowledges that some aberrations exist, that is, some places do not fit their regions. These include New York City and Washington, DC, both of which are located in the Foundry region but are different from it.
- 9 The reach of the language communities is limited to the Brussels capital region. The French-speaking community does not have authority over French speakers who live in the Flemish region, neither does the Dutch speaking community have authority over Dutch speakers residing in the Walloon region. See Swenden 2003.

## **Part II**

# **The Fiscal Framework**



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# Overview and Introduction

*Michael A. Pagano*

A key purpose of government finance is to generate revenues for the provision of public goods or goods that have the qualities of being “non-excludable” (one’s consumption of a good cannot exclude someone else’s consumption of that good, such as mosquito control, national defense) and “non-rival” (goods whose consumption does not diminish the amount of the good available to the next person). Some goods can exclude payers (such as “toll goods”), but cannot diminish the quantity available to the next consumer, such as turnpikes, toll bridges, parking meters. Some goods cannot exclude payers, but are rivalrous, which are called “common-pool resources,” such as aquifers, fishing grounds, petroleum reserves. Governments must find mechanisms of revenue-generation for these types of goods as well as for those that citizens deem “meritorious” of government funding and provision. How state and local governments in the US go about the business of generating revenues from taxpayers and ratepayers for these types of goods is the focus of this unit.

## **Resource-extracting systems**

The first task of any government is to create systems of resource extraction. The contributions to governing systems often mirror what the individual contributed to the general economy. Serfs paid the sovereign with agricultural products, fishermen with a tax on fish, shepherds with livestock, etc. The modern state is in the position of ensuring that everyone pays her fair share, that everyone contributes to his ability, and that the tax system does not distort general market forces, unless it does so deliberately as a regulatory or punitive action. The challenge then is matching the government’s fiscal structure with the economy. This is a particularly important challenge in the 21<sup>st</sup> century as the nation’s wealth is no longer represented only in land holdings.

In the 19<sup>th</sup> century, a tax on land was a fair tax on the nation’s largest wealth-producing asset and, obviously, on holders of wealth. Not only was

this a fairly good measure of wealth, this form of wealth was (and is) place based, meaning that it was not mobile and could not move to another spatial location to derive better returns. As the modern economy's wealth is now more likely to be reflected in intangible assets, such as stocks and bonds, the contribution of real estate to the economic engines of growth in any one society is diminishing.

Fiscal structures, as a consequence of this restructuring of economic systems and wealth generation, must be adapted to the changing economy.

Jeffrey Chapman's analysis of the mismatch between the government's fiscal system and the underlying economy is a careful examination of the changes in the long-run tax base changes as a function of the changes in the underlying economy. He also examines the current state of public finance, especially the exemption of certain activities from taxation (pre-emptions imposed by the federal government on states and localities), such as e-commerce and remote (catalog) sales. He does provide ample evidence that governments are responsive to changes in their fiscal system (e.g., issuance of Certificates of Participation, reactions to "soft" constraints) as an indication that governments behave strategically. The chapter raises concerns about matching fiscal systems to the underlying economic structure and it raises even larger concerns about the underlying motives of governments to shift costs to other governments and/or to other taxpayers. His discussion of "hard" and "soft" budget constraints further introduces the notion that a certain level of government can become involved in the financing of other governmental units. Important to his analysis is whether hard or soft budget constraints influence the strategic behavior of these other levels of government.

## Diversity

In a federal system, one is struck by the "unique" structures of each government's revenue portfolio and expenditure system. Indeed, even though local governments of a specific state in the United States may have similar fiscal structures, none is identical. The constellation of government financial structures is truly immense. Many special districts are granted access to two revenue sources, debt and user charges, but even debt must be retired by user charge financing. Others have access to a range of revenue sources, including taxes on consumption, wealth, and land and personal property. Economists argue that the more diversified revenue structures, the better a government's capacity to forecast future conditions and the better able it is to plan.

Many governments are constitutionally or statutorily proscribed from taxing certain activities, such as nearly all states' prohibition on taxing services (e.g., legal, medical, accounting). Many are also limited in what they can tax (e.g., food and prescription drugs are often excluded from the retail

sales tax base) or the amount of a levy is restricted or the growth rate in revenues is linked to a formula. These Tax and Expenditure Limitations have the effect of reducing the autonomous exercise of fiscal powers.

W. Bartley Hildreth details own-source finances and debt and has a keen insight into the nuances and complexity of finances in the US case. He develops “stress indices” for the property tax (after an examination enumerating the differences in property taxation across the states and the regulatory limitations imposed on the property tax) and for the sales tax (after a similar examination of the differential definitions of the sales tax base and rate). The ranking of the states along those indices provides a fascinating insight into the diversity of tax structures. He concludes that the “stress index” can indicate one of two contradictory conclusions: one, it might mean that a state that ranks high on the “stress” index could or should reform its tax structure. Or, two, it could mean that a state that ranks high on the “stress” index is only following the wishes of the state’s taxpayers. If local autonomy in deciding on one’s fiscal system is important in federal systems that emphasize local accountability, knowing the answer to that question is highly important.

## **Intergovernmental fiscal flows**

It is not unusual in federal systems to create a system of fiscal transfers from other levels of government (often “higher” levels of government) for purposes of equalizing services, promoting larger quantity of services (income effect/price effect), ensuring minimum standards, and transferring wealth. Federal fiscal flows in the US to states had been quite minimal until 1863, mostly involving collaborative river and harbor work with states. The involvement of the federal government in highway transportation in 1916 was a sea shift in the relationship between the two sovereign governments. The Great Depression of the 1930s, however, changed the federal system of fiscal flows in ways that continue to be felt today. Federal-state coordinated programs in health, welfare, education, public works, transportation, and even “regulated” state militias (national guard) have flourished.

Christopher Hoene’s analysis of intergovernmental fiscal flows in the US does not reach back to the 19<sup>th</sup> century, but it does provide a glimpse at the intergovernmental system as it has evolved in the 20<sup>th</sup> century. Hoene provides an overview of the evolution of the American federal system, the role of intergovernmental fiscal intervention in the affairs of the other governments, a good description of shifts in federal largess, in particular, and of the interrelationships between state and local governments. From an historical perspective, the intervention of the federal government into the affairs of local and state governments has been pronounced only in the last 30 years. Federal preemptions and mandates carry with them the twin possibility of diminishing autonomy and of ensuring homogeneity across

state and local governments. He concludes by calling for a new round of “sorting out,” which would be extremely important in deciding on what functions ought to be supported by a higher level of government.

These three chapters present an outstanding overview and insight into the functioning of the intergovernmental finance system in the US. The strength of federal, state and local governments rests on their authority to create fiscal structures that are both fair in extracting resources and open and dynamic in providing services and participatory opportunities that reflect the demands of the residents. Our attention continues to be on the politics, economics, and the fairness of governmental finance systems that provide services to their citizens.

# 5

## Wealth and Tax Systems

*Jeffrey I. Chapman*

What are the economic criteria for a successful federal system, especially when changes in economic conditions occur? Over time, varieties of both exogenous and endogenous economic effects occur within a federal system. Consumers may change their consumption patterns, technology will change, interjurisdictional relationships may deteriorate or improve, and general economic conditions will go through cycles. These changes, in turn, will lead to endogenous changes in governments' behavior, which will then affect the system's equilibrium. This chapter analyzes the impact of these changing economic effects on a federal system of government. It emphasizes the different ways that the system can change, note empirical work on the magnitude of these changes, and then attempts to analyze some policy issues. While this chapter does not fully answer the question posed in the first sentence, it provides some insights as to the necessary economic conditions for the long-run success of a federal system.

The following six sections address several issues. Section I very briefly reviews federalism theory, with a concluding emphasis on what economic analysis can contribute to the discussion. Section II discusses tax-assignment problems and revenues. This section also explicates some theoretical touchstones that can be used to view the implications of changes in tax bases and rates that subnational governments implement as they attempt to maintain their revenue levels. Sections III analyzes how the tax structures designed to raise adequate revenues may shift over time. It discusses the division of revenue authority among the levels of government in a federal system and raise additional fiscal problems and concerns. Section IV discusses the subnational governments' searches for new revenue sources; then Section V briefly discusses corruption and federalism. Section VI ties the analyzes together and recommends policy options. This chapter only briefly mentions such crucial topics as the economic analysis of revenue transfers, debt and capital finance, and the role of tax and expenditure limits, which are discussed elsewhere in this

volume. Further, this chapter ignores lesser-developed countries and the countries transitioning from socialism.

### **Section I: a very brief review of federalism**

Deconcentration of power is a major thrust of contemporary reforms across the globe. It often involves the devolution of nation-state authority to both regional and local levels with the concurrent decentralization of responsibilities and operations that had been the province of national governments. This dispersion of authority and responsibility is an old characteristic of American federalism. In the United States, this deconcentration movement of the last third of the 20<sup>th</sup> century has been described as a reaction to welfare-state centralization (Newland 2004).

American federalism is thus very much alive. It is opportunistic and changes over time, reflecting the relative strengths and goals of society's interest groups (Nathan 2006: 1). As the liberals have rediscovered that the states are the appropriate level of government to address such issues as health, environmental concerns, education, end-of-life decisions, and teaching of evolution, it demonstrates that there is an ideological balancing role to federalism – it provides a series of opportunities throughout the nation for citizens to make known their varied values (Nathan: 3). Nathan defines federalism as having four characteristics. It is opportunistic, in that its existence allows citizens who are out of power nationally to advance their ideas from the periphery; it is dynamic because it allows change to occur over time as the goals and values of society change; it is cyclical in that these changes coincide with the mood of the country and, implicitly, reinforce that mood; and it is pro-government, in that its shifting character leads to an increasing public-sector activism and thus spending over time. The political values of these characteristics lead to diversity among regions, flexibility in problem-solving, the provision of opportunities for experimentation and innovation, and the expansion of opportunity for participation in political processes. In this sense, a federal system is a safety valve. It allows for accommodation, innovation, and political adjustments. It is a way to make sure that over time the political system is open to multiple values and views. It is sometimes untidy, hard to manage, and uneven. Because of these implications, Nathan concludes that the dominant effect of US federalism is to expand the scope and spending of the domestic public social sector (Nathan: 7).

Acknowledging that decentralization has its pitfalls, including potentially increased disparity across regions, loss of macroeconomic stability, and institutional capture by local factions (especially in highly unequal societies), the World Bank (1997) argues that decentralization offers a chance to match public services more closely with local demands and preferences and in so doing, increases the chances of building a more respons-

ible and accountable government which has been built up from below. The Bank believes that three major recent developments have increased the demand for formal political decentralization: the minimum size of self-sufficient government has declined, political choices have given voice to local demands, and countries often turn to local and regional governments when the central government has persistently failed to provide essential services (p. 120). The Bank concludes by suggesting decentralization strategies for high and low local government capacity and high and low central government capacity. If both governments have low capacity, the Bank suggests a cautious strategy; with local governments having a high capacity while the central government has a low capacity, one strategy should be delegation according to the priorities of governments. If local governments have low capacity while the central government has high capacity, some services can be deconcentrated as well as some targeted strengthening of local entities during this transfer. Finally, if both governments have high capacity, then devolution should occur both according to government priorities as well as articulated needs.

The above discussion has slowly moved from a pure political strategy of federalism to one that involves the economic concept of efficiency. It is not surprising that a strong case has been made in the economic literature for a federal system of government. Oates (1972, 1999) has long argued that there is a range of public services that are of local interest and that the demand for these services (as well as their costs) varies across jurisdictions. Therefore, their economically efficient level and form will also vary. Further, for both political and informational reasons, central governments are unlikely to provide the efficient pattern of local public goods. This phenomenon is recognized by the European Union, under the *Maastricht Treaty's* principle of subsidiarity which argues that public-policy decisions should be assigned to the lowest level of government that has the capacity to achieve the objectives.<sup>1</sup>

Economic theory cannot always lead to a determinant solution pertaining to optimal fiscal decentralization. The arguments for fiscal centralization are stronger in developing, rather than industrial, countries (Bahl and Linn 1992) primarily because of stabilization and redistribution reasons.<sup>2</sup> The case for decentralization is stronger for developed countries in which cities could levy taxes that charge residents the full marginal cost of urbanization, adjust budgets to local preferences (leading to a more efficient distribution of local public services), and might be able to tax some sectors more easily than the central government (Bahl and Linn 1992).

Decentralization can be viewed from either the bottom looking up or the top looking down (Bird and Vaillancourt 1998). Political values are important when the bottom-up perspective is used – local responsiveness and political participation are increased as well as allocative efficiency. From the top-down viewpoint, one rationale used to justify decentralization may be



to make the central government's life easier since responsibilities for both providing and financing the services would belong to the subnational units. Further, higher levels of government may deliberately decentralize expenditure responsibilities to lower levels and, perhaps irresponsibly, assume that the lower levels will be able to provide the necessary resources. However, because of institutional constraints, for example super-majority requirements to raise taxes, these lower levels are often unable to raise the necessary revenues to finance the expenditures. In these cases, service levels are likely to fall. A recent study (Shadbegian 1999) finds that in the United States, as fiscal decentralization increases, state and local public expenditures increase; federal government expenditures decrease, and total government spending decreases.<sup>3</sup>

An additional concern is the degree of mobility of goods, services, capital, and people (in their roles as both consumers and workers) among units of government. The greater this mobility (both *de jure* and *de facto*), the more difficult it is to construct an efficient decentralization regime. For example, sometimes it is asserted that (in the United States) high taxes on mobile capital may cause that capital to relocate to lower-taxing jurisdictions. In an examination of Swiss Cantons, Schalter (2003) investigates where interjurisdictional spillover effects are a serious problem for an efficient decentralized-fiscal policy. The author notes that if there are spillover benefits, there is potential free riding from the recipient jurisdiction and perhaps an under-provision of public services. This chapter finds that spillover effects among Cantons play a minor role and are significant only in public welfare and finance spending. Note that this is consistent with the argument that welfare problems are best handled in a centralized fashion.

## **Section II: the assignment problem and general revenue sources in a federal system**

How revenues and expenditure responsibilities are assigned to a subnational set of governments determines how dependent upon a particular revenue source a particular subnational government becomes. If this revenue source then changes, problems may appear that the intergovernmental system may find difficult to solve.

### **Assignment concerns**

Tax assignment is establishing what level of government should determine the tax base and set the tax rate as well as collect the resulting levy. McClure (2001) argues that before these powers of taxation can be assigned, an entire system of variables must be examined. These variables include the country's state of development; the importance of primary products, manufacturing, and services; natural resources' concentration;

the development of the capital market as well as the interstate and global markets; the state of technology; the capacity for tax administration (and compliance); and the importance of efficient resource allocation compared to income redistribution and stabilization.

These variables' relative importance allows the country to begin determining the answers to McClure's five questions regarding any proposed tax-assignment solution. These are: which level of government (1) gets the revenue; (2) chooses the type of taxes that are levied by any particular level; (3) defines the tax rates; (4) sets the tax rates, and (5) administers the taxes. McClure argues that when subnational governments lack control over all these decisions – even if subnational revenues adequately meet the particular subnational government's expenditure needs – vertical-fiscal imbalance exists. This vertical-fiscal imbalance might be exacerbated or partially alleviated by hierarchical relationships between the central and the subnational governments (see Section IV).

Three generic approaches, not all of which are mutually exclusive, can be used to answer the questions in McClure's model. The first is to have each jurisdiction at a given level of government answer the five questions anyway it wishes, subject to constitutional prohibitions. This is the Canadian and US system and might be called the local-government autonomy solution (Chapman 2003a). The second approach is one of administrative differences. In this case, one level of government administers the taxes for another level. For example, some American states rely on the Internal Revenue Service to determine the appropriate tax base, but then add a surcharge for their own state income tax. In California, the counties may have different sales tax rates, but the state collects and then returns taxes to the county. The third approach involves tax sharing, with one level of government sharing revenues with another level of government. (Note that this is vertical, not horizontal sharing). While McClure argues that typically revenues are returned to where they are deemed to originate, it is often controversial in the United States as to whether any state is getting its "fair share" of collections returned. This third answer does not directly address tax-assignment issues, but is rather an intergovernmental grant – a linchpin of federalism that complements the assignment question.

McClure draws several recommendations and implications. In particular, if it can be argued that redistribution and stabilization policies are best done by the central government, then local governments should have the power to set their tax structure to reflect the benefits of public services they provide. Eliminating the redistribution function does not preclude state and local governments from using individual income taxes, but if they do, they should not be progressive.<sup>4</sup> Because of McClure's support of benefit taxes, and his belief that the benefits of public services occur where people live, residence-based income taxes and sales taxes not returned to

point-of-sale are preferable to income taxes levied by jurisdiction of employment. This benefit-tax belief is consistent with Tiebout's (1956) model of local public-sector efficiency and McClure endorses tax competition between subnational governments to help reach this efficiency.

McClure recognizes that there is no one perfect system of answers to the set of tax-assignment problems. Present tax assignments often are based on past political bargaining in a particular historical situation (Bird 2000). Tax assignment based on current taxes or on taxes that currently are prohibited is not likely to address adequately problems associated with any new taxes that did not exist at the time assignment was made. As the economy evolves, assigning a particular tax to a particular government level, which might have been appropriate at one time, may become inappropriate as the technology of taxation changes, the understanding of the effects of taxation increase, and changes in the economic environment occur. Unfortunately, changing an existing tax assignment faces serious adjustment costs, both technological and political. These transaction costs limit the ability of subnational governments to respond to the changes discussed in Sections III and IV.

### **Potential tax bases and tax theory**

In the United States, with at least a modicum of fiscal autonomy, state and local governments can draw revenues from a variety of sources. States generally collect money from income taxes, sales taxes, and several different fees and charges. Cities and counties collect revenue from sales taxes, property taxes, sometimes income taxes, enterprise charges, and an assortment of miscellaneous sources.<sup>5</sup> Nearly all subnational units receive some inter-governmental aid – states obtain it from the national government; cities and counties get it from both the state and national governments. Most cities, counties, and states have the ability to issue some types of debt.

In the United States, there are significant differences between the theoretical tax base and the base that is actually used. Although the Haig-Simmons definition of income is probably the most theoretically correct, in practice there are numerous institutional imperfections in the way that income is measured.<sup>6</sup> These imperfections reflect political solutions to such problems as how to count income-in-kind, value a stay-at-home spouse, ignore imputed rent on owner-occupied housing, and so forth. The income tax is primarily a central government and state tax, although in some regions of the United States, it is nearly ubiquitous at the city/township level.<sup>7</sup> Since the US central government is continually changing the tax code, measures of the amount of taxable income often change. As will be seen in Section III, these changes may affect subnational government revenues and lead to tax-assignment changes.

The consumption tax base in the United States varies from state to state (and within some states, from jurisdiction to jurisdiction). For example,

sometimes food and medical supplies are not taxed, some services are taxed, and some types of e-commerce are taxed. Cigarettes and alcohol tend to be taxed heavily. Both *ad valorem* and excise taxes exist, with rates and amounts varying among jurisdictions. The sales tax is principally a state tax; however, some local governments are heavily dependent on sales taxes in some specific states.<sup>8</sup> It is interesting to note that the Bush administration's income-tax cuts contain provisions that exempt a large amount of savings. This can be described as a step in changing income tax to a national consumption tax.

The property tax is one of the most controversial of today's subnational taxes. In the late 1970s, property tax limits became very popular and now over half of the states have imposed rate or base constraints on local-property taxes. As with the other two taxes, there are serious distortions in the way that the base is measured and now only land and improvements are counted in most jurisdictions.

Under certain conditions, the property tax acts as a benefit tax, since the property tax funds the operations of many local services that benefit the owners of immobile property. Nearly all empirical work supports the contention that these benefits and taxes are at least partially capitalized into local property values and programs with benefits greater than costs, tends to bring in positive net benefits to local residents. This applies to property taxation of local businesses as well as residents. Often in the United States, property of different types is taxed at different rates. For example, in Pittsburgh, land was separately taxed at a higher rate than improvements and inventories until 2001. Since land is immobile – while in the intermediate run structures can be mobile, this split encourages stability (Oates and Schwab 1998). A final benefit of the property tax is that it is clearly visible to the local residents and thus leads to local-fiscal accountability.

The charges category represents what subnational governments are doing to counteract some of the imposed tax limits. The charges include charges for services (e.g., garbage pick up fees), impact fees on house construction, and charges for utilities. If set correctly, these charges can lead to a more efficient allocation of resources. Enterprise activity is also included in this category.

These combinations of taxes reflect, again in the aggregate, a balanced approach to tax collections with little concern about equity or economic stabilization. However, if jurisdictions begin to compete, these latter issues can become more important as property-tax abatements, sales-tax rebates, or economic-development incentives become more important and affect tax-assignment issues.

### **Intergovernmental revenues**

Intergovernmental grants must be considered as an addendum to the tax-assignment problem. Although technically these are flows of money – not

taxes – they reflect a sense of government functions' alignment to levels of government. In an efficient federal system, money should follow, not precede, functions (Bird and Vaillancourt 1998).

At a theoretical level, local lump sum grants should have effects that are identical to the case in which the funds are distributed in a lump-sum manner to the local residents; that is, local-expenditure response to the grants should be similar to the effects of an increase in private income (Gamkhar 2002; Bradford and Oates 1971). However, there is a great deal of empirical work that has rejected this conclusion – apparently the expenditure stimulus from unconditional grants exceeds that of the stimulus derived from equal increases in private income. This is known as the “flypaper effect” – money sticks where it hits and grants stimulate state and local spending (see Bailey and Connolly 1998 for a summary of the literature).

During a period of grant retrenchment, at least in some cases, states and localities responded to grant cutbacks by absorbing most of the difference. They attempted to increase their own revenues to try to maintain existing levels of current programs. There may be a basic asymmetry at work: state and local spending is highly responsive to increases in grants, but relatively insensitive to losses of grant funding. Money may stick where it hits, but comes unstuck without leaving a hole (Gamkhar 2002; Oates 1994). This asymmetric replacement varies by state and local government as well as by program. Some studies have suggested that state funding has replaced lost federal aid because states have raised taxes and increased fees and charges. However, these alternative sources and amounts of revenue are likely to vary across jurisdictions and programs (Gamkhar 2002). A movement toward increasing federalism may lead to this increasing innovation if the underlying fundamental base, rate, and political relationship variables change.

There are several reasons why these dollar replacement activities may occur. In particular:

- Programs may develop politically powerful clientele which makes it difficult to cut programs when grant funding falls (Gramlich 1987).
- There are no additional intergovernmental revenue sources available.
- Cuts in grants may induce fiscal retrenchment with an actual reduction in support of the affected programs from own-source revenues (Stine 1994).
- Spending decisions made by recipient governments are likely influenced by budget reserves, so that governments that have moderated expenditure growth (and/or tax cuts) can afford to use a part of the reserve (Wallin 1996).
- There may be limited flexibility in allowed response to reductions (Shapiro and Sonstelie 1982); for example, grant formulas might carry

maintenance of effort requirements in order to receive the next allocation of that grant.

### Federalism and its affects on base and rate definitions

An increase in mobility has the potential of changing the economic environment of a subnational government in a dramatic way. In the EU states, there is a commitment to guarantee the free movement of goods, services, capital and labor among all member countries without any legal obstacles. This mobility can affect the mix of tax types and the variety of tax-base definitions, tax rates, and fees and charges (Wellisch 2000). Examples of this mobility caused variation are seen in the United States (see Table 5.1), which has population-mobility rates between ten and 15 times those of the EU. Of course, many of these examples are the results of an economically competitive public-economic environment. Some of these taxes are enacted merely to keep other taxes low, some to attempt to export the burden to non-residents, some to address the prospects of economic competition with other jurisdictions, and some for efficiency purposes.

As Wellisch demonstrates, under certain conditions, if there is perfect competition as well as mobile firms and households, then interregional competition will lead to an efficient resource allocation in the case of a complete set of tax instruments. However, as Wellisch also shows, if his ideal tax system is not feasible (see next section), then regional governments will systematically under-provide local, public-consumption goods, since they will be forced to tax the capital base (part of which is mobile) to finance local public goods. It is the fear of this mobility, given the competitive environment, that forces too low a tax rate. However, this potential interregional tax competition may ultimately cut expenditures that serve

**Table 5.1** Examples of variation of revenue sources in the United States

Variation in Type of Revenue Source	Variations in Application
Tax types	Sales, personal income, corporate income, property, utility, gaming
Tax base	Taxable items defined differently by cities, counties, states; specific services, types of property; types of income; types of alcohol
Tax rates	Sales tax rates vary by city, county, state; income tax rates vary by city and state; property tax rates vary by city, county, state, type of property; corporate rates vary by state
Fees and charges	Response to false burglar alarms, impact fees, building permit fees, traffic fines

only the (self-serving and wasteful) politicians or bureaucrats and thus may be in the interests of citizens (Wellisch 2000: 23).<sup>9</sup>

The above models may need more than just tweaking to make them correspond to reality. Too many discontinuities, market defects (including information asymmetry), and rent-seeking behaviors exist to allow this elegance to spill over into practice. As Bird and Vaillancourt (1998) argue, the essence of decentralization is that each particular country, with its own history, traditions, and specific institutional, political, and economic context, will decentralize in a different way with different results (1998). For example (some based on Bird and Vaillancourt):

1. If countries decentralize more expenditure responsibilities than revenue sources, service levels will fall or local governments will ask for more intergovernmental transfers or issue more debt to cover the responsibilities. If local governments are given more revenue autonomy, however, then local revenue mobilization may decline – since local governments may cut taxes for competitive reasons, especially if there is a mobile-tax base.
2. Correct-tax assignment is not necessarily clear in principle or practice. It is not unusual to find that the central government can collect taxes more efficiently than local governments (both in developed and developing countries) and the potential tax bases that can be used by local governments vary wide among regions. The basic principles of assigning revenues to subnational governments include: (1) own-source revenues should be sufficient to enable at least the richest local government to finance their locally provided services, which benefit local residents; and (2) local revenues, to the greatest extent possible, should be collected only from local residents, preferably in relation to the perceived benefits they receive from local services. This is an implicit argument for an extensive use of land taxation.
3. Costs of the local fiscal decisions must be borne by those who make the decisions. There should be minimum funding at the margin from transfers from other levels of government with the best transfers being lump sum and unconditional, so the recipient is responsible for funding program expansion.<sup>10</sup>
4. Accountability to both the taxpayer and the recipient of the local public good is a crucial component of successful decentralization. This includes:
  - Political accountability to constituents, which further implies transparency as a part of determining activity by government level and how the fiscal institutions of the federal system will attempt to adjust for the differences in needs and capacities among different governmental units at the same level of government.

- Administrative accountability necessitates a clear legal framework with respect to responsibility of both collection and expenditure functions of the local government.
- Economic accountability means that local residents are responsible for paying for local services. This, in turn, necessitates that local authorities have some tax autonomy and implies that the best form of intergovernmental transfer is a lump-sum amount, which is fixed in advance and which will not vary because of any action by the recipient.

How these issues are resolved is related closely to the ongoing debate concerning the values of political participation and economic efficiency, with special emphasis on their integration into a federal framework (for more on this, see Inman and Rubinfeld 1997).

5. Management issues are important, with poor management potentially leading to inefficient outcomes. Suitable and well-trained staff, a sound accounting and financial reporting system, and adequate technical support are necessary for the fiscal flows to be used efficiently. This means that both the central and subnational governments must spend money for education and training.

A US example of just a portion of the complexity of a federal system that occurs when reality invades theory is seen in Tannenwald (2002). In this piece, questions revolve around a state's capacity to raise revenues, how that capacity is used, and whether that capacity is sufficient to finance the state's need for public services. Tannenwald utilizes the concept of a representative-tax system and a representative-expenditure system.

Tannenwald finds wide variation among states in both indices. He interprets his conclusions by noting that states differ in the level of fiscal services they demand from their state and local governments. Additionally, more intergovernmental aid from the central government might induce some states to provide an inefficient higher level of public services, while inducing other states – that are more fiscally comfortable – to provide a level of services that is too low. Yet, he also believes that if fiscally stressed jurisdictions face inherent disadvantages in economic competition for workers and employers, then tilting the federal-aid formulas might be justified. Thus, different subnational governments in a federal system might choose to have very different revenue and expenditure activities.

An additional level of importance is attached to Tannenwald when state revenue growth changes differentially among states. For example, during the recent recession and very slow recovery in the United States, real state-tax revenues had declined for eight consecutive quarters, until they began to show a small real increase in the third quarter, 2003 (Jenny 2003). In response to this decline, states increased tax rates and/or bases for five consecutive quarters. There is variation among states – some saw revenue



declines during 2002 of between 7 and 8 percent, while others saw increases of over 7 percent. Differences in fiscal capacity might affect the discussion of the appropriate role of intergovernmental revenue flows.

### **Section III: some additional concerns for federal systems**

This section focuses on endogenous, non-macroeconomic, fiscal interdependencies among the central government, state governments, and local governments. Often considered second-order effects, these concerns have an impact on the success of a federal system. They are often political in nature.

#### **The politics of tax limitations**

This chapter argues that there are at least four factors of tax limitations that relate to federalism.

1. In the United States, the modern version of tax limitations began in 1978 in California with a draconian property-tax limit passed by initiative. This limit came about for two reasons. There was a very large housing bubble developing, which was causing large increases in the property tax levy, and the state government could not reach a consensus on how to enact property-tax reform. Because of this breakdown in state-local interactions, the initiative passed. The concept of tax limits became very important throughout the United States and now a majority of states has some sort of constraints on taxes, expenditures, or both. A by-product for many states is that a supermajority of the legislative body is necessary in order to pass tax increases.
2. These political-tax limits constrain the ability of local governments to raise money through the ordinary-tax system. This loss in autonomy makes them weaker and, thus, weakens federalism.
3. Because of the inability to raise enough taxes, local governments often turn to the state for funds. However, rather than merely giving non-earmarked aid to the local governments, the state has engaged in a variety of methods to pass through money. For example, the state may increase funding for education and then allow the local governments to take part of the property-tax base that was going to the school district. Alternatively, the state may shift the responsibility for particular programs to the local government along with a share of the tax revenue. Over time, if the local expenditure responsibility increases at a faster rate than the revenue received, there is additional fiscal stress on the local governments.
4. Local governments have not been passive in the face of the new intergovernmental relationships that have led them to a local-tax dilemma. Rather, they have engaged in a variety of fascinating activities. The

result of these activities is a financial system – at both the local level and the intergovernmental level – that is virtually impossible to penetrate. Citizens become distrustful of government and, in the United States, seem to be opting out of the decision-making process, as exemplified by a decline in voting rates. Most importantly, this increasing lack of transparency is legal; it results from local government officials (often with the aid of private sector attorneys and financial advisors) doing their best to ensure that appropriate and adequate levels of services be provided.

### **Tax interdependencies**

The central government can affect the fiscal abilities of subnational governments through manipulating the tax system. It can do this by changing the tax itself, the tax base, and the tax rates.<sup>11</sup> An example of the first occurred in the United States when the central government implemented a scheduled increase in the deduction levels for the estate tax, with the deductions scheduled to increase until there would be a final elimination of the tax. Since states, through a tax-credit system, were allowed to collect a portion of the federal tax, this elimination lowered state-tax collections.<sup>12</sup>

The central government also has the ability to change the tax base. For example, the central government has increased the income-tax deduction for the number of dependent children for a household. This lowers the tax liability for the federal income tax. To the extent that a state bases its definition of taxable income on the federal definition, it too will see a reduction in its tax collections, through no action of its own. The same phenomena occurred in a change of the US corporate-income tax. The national government decreased the corporate tax by changing depreciation rules. This decreased the tax liability of corporations for their national-corporate tax and, at the same time, for the same reasons as mentioned earlier, decreased corporate liability at the state level.<sup>13</sup>

By cutting tax rates, the central government also indirectly influences a federal system. By cutting rates, the government will receive less revenue, which is likely to affect future intergovernmental-revenue grants.

State-local relationships also exhibit several of these characteristics, although with different nuances. For example, although it is feasible for the base of a state-sales tax to differ from the base of a local-sales tax (it does, for example, in the state of Arizona), it is usually more efficient for them to be the same, with the state determining the base. Further, the state may be able to pass legislation that sets the sales-tax rate for all of a particular type of local government (in California, all cities have the same base sales-tax rate, although counties can differentially add to the rate). The state also has the power to establish different property-tax rolls that are assessed at different ratios. For example, in Arizona, residential dwellings are assessed at 10 percent of market value, while commercial dwellings are assessed at 25 percent of market value. By changing these rules, the state can affect the

property-tax flow into a city. The state can also affect the ability of local government to change its revenue system, for example by requiring a supermajority vote to establish a new tax or assessment district. Of course, local governments in states that have initiative processes always face the possibility of tax-limit initiatives, which are likely to constrain tax bases, tax rates, and the ability to change the tax system.

Esteller-Moré and Solé-Ollé (2002) developed a theoretical model that focuses on tax interdependencies. In this model, they conclude that if both the regional and federal levels of government occupy the same fields of taxation, then tax-rate increases by one layer of government will reduce the taxes collected by the other. They also find that if the tax base is mobile, tax rate increases by one regional government will raise the amount of taxes collected by other regional governments. Applying their model to Canada, they find that there is a significant positive response of provincial-tax rates to the federal income-tax rate and the tax rates of competing provinces.

### **Intergovernmental revenue flows**

These intergovernmental-revenue flows are an important component of federalism. The justifications for these flows typically are based on either income-distribution concerns or ensuring an efficient level of public production (where positive externalities exist, so that optimum production is larger than what the perfect market would produce).<sup>14</sup> In the United States, there are literally thousands of intergovernmental grants, given in a relatively uncoordinated manner and often audited solely on use. They are virtually impossible for the average citizen (or even elected official) to track. Often grants from the same federal agency go to several different state agencies, which then may flow to several different programs delivered at the local level. Further, the use of different acronyms, sometimes for the same agency, makes any sort of analysis very difficult.

Because of the asymmetric reactions to grants increasing or decreasing, it is not clear whether intergovernmental grants should be considered exogenous or endogenous to the state or local government. It may be that they are initially exogenous but ultimately become endogenous. Of course, if these intergovernmental transfers do not address income or externality questions, then a more careful set of evaluation instruments – addressing soft and hard budget constraints – need to be developed before the process starts. This will be discussed in Section IV.

The reverse side of intergovernmental grants is intergovernmental mandates. In these cases, the central government decides that there are common requirements for service that exist across states and localities. In the United States, these mandates typically deal with potential discrimination against minorities, the elderly, and the handicapped as well as protecting the environment and consumers from unsafe activities or fraud. These

mandates affect both the public and private sectors. States have often imposed mandates concerning health and welfare eligibility on sub-state governments and recently the national government has imposed mandates concerning education. These mandates are not cost-free, even in the cases in which intergovernmental grants accompany the mandate.

### **Horizontal intergovernmental concerns**

Horizontal federalism relates to the relationships among governments at the same level. Although Tannenwald (2001) puts intergovernmental competition in the same category as changing-tax bases and technology, both of which are exogenous, this chapter will treat the interjurisdictional competition as an endogenous response to these problems and they will be discussed in the next section. However, to foreshadow, intergovernmental competition – depending upon the circumstances – may lead to efficiency gains or an under-provision of public goods.

## **Section IV: responses to changes**

The responses of subnational governments to these concerns depend upon the availability of revenues. The type of budget constraints that local governments face in part depends on whether it is in a soft-constraint or hard-constraint environment. This, in turn, is set by the relationships between the higher and lower levels of government.

### **A theoretical framework**

The concepts of hard- and soft-budget constraints are useful tools in examining the activities of subnational governments that are facing challenges to their fiscal base.<sup>15</sup> A soft-budget constraint exists when the subnational government can confidently expect the central government to bail it out financially under a fiscal-stress situation. The expression “soft-budget constraint” thus describes the situation in which a subnational entity can manipulate other governments to share their funds in order to allow the manipulator to spend money in undesirable ways. A soft-budget constraint exists when there is not a fixed *ex ante*-revenue constraint for the subnational government.<sup>16</sup> A hard-budget constraint is the situation in which the subnational government is convinced that the bailout will not occur. When budget constraints are soft, a subnational jurisdiction can increase expenditures without facing the full cost of that increase, thus there are few incentives to constrain overspending. If the budget constraints are hard, however, then the subnational government recognizes that it will have to face undesirable consequences if it overspends (Rodden, Eskeland and Litvack [REL] 2003).<sup>17</sup>

Decentralized countries particularly may be susceptible to overspending in situations of soft-budget constraints, because there is a likelihood that

these subnational governments will learn to put their own interests – as well as their constituent interests – before those of the larger country. In this case, decentralization can possibly undermine efficiency because each jurisdiction may generate excessive expenditures (some of which may generate unintended positive spillovers) if the local government believes that the central government will, *ex post*, financially accommodate these expenditures and there will be either excessive spending or too little tax effort at the subnational level.

Expectations of bailouts – *ad hoc* additional funding that appears when a jurisdiction can no longer service its obligations – often reflect soft-budget constraints. As REL explain, bailouts are a sequential game, which has an underlying component of incomplete information about both the credibility of the central government’s commitment and the importance of the activity that must be funded. There are three stages to this sequential game:

- Stage 1: The central government announces financial policies regarding subnational governments. It establishes institutions and laws that are designed to help in administering these policies. One of these policies is the explicit declaration that subnational jurisdictions will never be bailed out.
- Stage 2: The subnational jurisdictions carefully examine the central governments’ institutions, statements, laws, and policies in order to assess the central government’s credibility toward its no-bailout pledge. The subnationals then decide whether to spend and borrow subject to their own fiscal constraints or to adopt an unaffordable policy that provides local benefits. If the subnational government decides to play the cost-shifting game, it will deliberately overspend and find itself in fiscal difficulties. It then asks the central government for help.
- Stage 3: The central government must now decide whether or not to provide a bailout. If the costs to the central government of not bailing out the local government exceed the costs of bailing them out, the central government reveals that it is not committed to a hard-budget constraint. If the local government has strong beliefs that the central government is not committed at the first stage, incentives to spend too much come into play at the second stage. This is a moral-hazard situation, based on a lack of knowledge of the central government about the local governments need for spending.<sup>18</sup> If local government believes that the central government is committed, it faces incentives that encourage it to live within its means.

There are several reasons why the central government may not commit to a hard-budget constraint. The central government may choose a bailout *ex*

*post* because it believes that if the local government failed to provide the particular service, there would be negative spillovers to other jurisdictions. In addition, if the local government has little tax or expenditure autonomy and is truly a subordinate part of the larger jurisdiction, then not bailing out the local government is merely a means of punishing its citizens and has little efficiency effects. The local government must have the means to match responsibilities with revenues that the central government can credibly commit to a hard-budget constraint. The central government must also have enforcement options to make the subnational governments act responsibly. Finally, as Wildasin (1997) demonstrates, large subnational governments tend to have more ability to extract welfare-improving bailouts than smaller localities. Credible commitments to hard budgets are quite rare.

The basic governance structure of the decentralized system may reflect not only the previously discussed bailout game, but also a set of institutions that are structured to encourage bailouts. REL define ten-basic fiscal and political institutional concerns that affect the probability of a hard-budget constraint being implemented successfully. The first column of Table 5.2 summarizes these factors.

Some of these cells need explanation. In Cell 1, unless the funding between governments is completely independent of the recipient jurisdiction's choices, the funding is likely to create moral-hazard problems between the central and subnational governments. The politicians in the subnational governments will face inadequate incentives to control their expenditures, since the expenditures will be subsidized partially by residents of other jurisdictions. The textbook-recommended solution – in the cell – is probably not attainable in practice. In Cell 2, transfer-dependent governments face weak incentives to be fiscally responsible. Discretionary bailouts are less likely if tied to explicit rules and criteria. Cell 3 refers to the potential under-provision of services to national constituencies – for example welfare programs or pensions. The central government needs to ensure that these constituencies are satisfied. Cells 4 and 5 reflect the need to constrain the subnational governments' political powers, which defend soft constraints. Cell 6 ensures that creditors will not believe that some third party with deep pockets will keep the subnational debt afloat if the jurisdiction attempts to default. This ensures the ability of the credit market to monitor the fiscal position of the jurisdiction. Cell 7 argues for transparency in the political/fiscal systems and assumes that voters will vote out fiscally irresponsible political leaders. Cell 8 argues that mobility – a necessary condition for tax capitalization – must exist. If mobility exists, then local-land markets give residents the incentives to understand and follow local public-fiscal affairs, since their property wealth will be determined by the interplay of benefits and the taxes necessary to fund these benefits. Cell 9 reflects the ability of the central government to regulate local subnational governments' borrowing, which is probably inefficient.

**Table 5.2** Requirements for a successful hard-budget constraint

Rodden, Eskeland and Litvack	Inman
1. Grants should depend on local choices only when this is the explicit intention.	A. Nationally elected political parties must have the ability to control the election prospects of local representatives. OR Nationally elected presidents must have the ability to grant or deny favors valued by local representatives and their constituents.
2. Tie intergovernmental transfers to rules/criteria that are not easily manipulated.	B. The central government must have efficient redistribution policies.
3. National political constituencies need to be accommodated.	C. There must be a mature banking system with interbank markets in demand deposits and a fully integrated national-capital market.
4. Political factors should favor national over local taxpayers.	D. There must be competitive suppliers of local public services.
5. Lobbyists from powerful subnational governments need to be constrained.	E. There must be a stable and long-lived central government.
6. Subnational fiscal decisions should be allowed to be disciplined by credit markets.	F. Clear and enforceable accounting standards must exist so that strategic deficits can be distinguished from truly exogenous local disasters.
7. Fair, free, and knowledgeable voters are present for elections.	G. There must be a well-managed macroeconomy to limit the frequency of such disasters.
8. Tax capitalization must be able to occur.	H. There must be an informed and sophisticated bond market.
9. Hierarchical mechanisms can be used by central government.	I. Adequate information must be available so that local deficits can be capitalized fully into land prices.
10. Clear, <i>ex ante</i> -bankruptcy laws must exist.	J. Local land markets have enforceable property rights and the market for property is competitive.

However, self-limits, sometimes written into statutory or constitutional law at the subnational level, might act as constraints on issuing debt. Finally, bankruptcy laws, in Cell 10, clarify how subnational crises can be solved before their appearance.

Inman extends the argument by examining the US-governance system through the lens of a federal system that utilizes a hard-budget constraint (Inman 2003). He particularly examines local fiscal discipline and the results that might occur if the local government's budget constraint is softened – because of bailouts and transfers from higher levels of government. Inman is concerned with the fiscal spillovers created when the subnational governments shift the costs of their public programs onto current or future non-residents (through these bailout mechanisms). He argues that this ability to cost shift will lead to an inefficient level of local services provision and, thus, orients his chapter to the development of structural rules to prevent softening the budget constraint through cost shifting.

For Inman, cost shifting can occur in three ways. First, local governments can shift the local services' production costs onto non-residents through central government funded transfers or by tax exporting to non-residents.<sup>19</sup> Second, local governments can borrow money for current expenditures through deficit financing and then refuse to repay the debts – thus shifting the costs to current lenders or to current national taxpayers. And third, local governments deficit finance current-period expenditures, but use deficit rollovers year after year, until the current taxpayers have left the local jurisdiction, thereby leaving future residents to finance debt repayments – probably through higher taxes. Inman believes that inefficient cost shifting occurs when central government transfer policies are set by a national legislature composed of independent representatives from local governments. In this case, because of the prisoner's dilemma character of legislative politics (see Weingast *et al.* 1981; Chari *et al.* 1997), cost shifting will win despite a national interest in prohibiting cost shifting.<sup>20</sup>

To control local cost shifting, it is essential to control the national policies that allow it. The right hand column of Table 5.2 summarizes Inman's derived conditions.

Inman argues that penalties must be imposed when representatives vote for a cost-shifting policy or extra rewards must be offered when they vote against a cost-shifting policy. These penalties and rewards must come from organizations or individuals with extra-legislative resources dedicated to encourage nationally efficient allocations. These are the justifications for the two alternative conditions in A. Conditions B and C ensure that distribution and financial costs of no bailout are low enough so that the no-bailout option is viable. Condition D is designed to accommodate the possibility of bailout uncertainty costs, and Condition E is necessary to ensure that the money saved from prevented bailouts is enough to justify the costs of building a tough, no-bailout reputation. Conditions F and G reduce the uncertainty that a central government might face in understanding the source of the local deficit. High uncertainty might weaken the resolve of the central government to not engage in bailouts. Condition H discourages inefficient local deficits that are financed through the debt



market, and Conditions I and J are necessary to prevent future residents from bearing the costs of an unfounded deficit that is not adequately disclosed.

Inman derives three regulations to ensure the continued existence of hard-budget constraints:

1. There must be a constitutional regulation that establishes a fiscal assignment limiting the ability of the central government to transfers that are only for demonstrable spillovers and limits local taxation to resident taxation.
2. There must be a constitutional regulation that establishes a no-bailout clause and a bankruptcy standard requiring local repayment of all local debts, enforced by a politically independent oversight board.
3. There must be a constitutional regulation of a balanced-budget rule that requires tax financing of all current accounts spending.

Inman then applies his model to the United States, a country that has seen only two instances of direct federal bailout in its history.<sup>21</sup> He concludes that while it is generally successful in establishing the principle of fiscal discipline at the state and local levels, this is a fragile fiscal discipline. In particular, there does seem to be evidence that locally elected US representatives tend to overbuy nationally financed local goods (Levitt and Snyder 1997; Inman and Fitts 1990; DelRossi 1995; DelRossi and Inman 1999; Wilson 1986; Collie 1988). In some cases this generates inefficiencies of as much as \$0.30 per dollar of aid at the federal to state and local levels and as much as \$0.10 per dollar of aid when examining the state to local level (Inman 2003: 56). However, most of the other conditions are met, although there is some concern that land markets are less successful in monitoring future benefits and costs if there is excessive local borrowing or under-maintained public capital.

### **Interjurisdictional competition**

Tannenwald (2001) includes interjurisdictional competition as one of the three elements that potentially lead to the obsolescence of state and local tax systems.<sup>22</sup> This interjurisdictional competition is endogenous to the localities' decision-making. Interjurisdictional competition is engaged in by the jurisdiction deliberately to attract mobile businesses, consumers, and wealthy populations.

Moderate fiscal competition is probably beneficial, improving the efficiency of state and local governments. In addition, if local jurisdictions compete to attract particular types of populations and business, then there is an increased likelihood a variety of different local governments will exist. This broadens the opportunity set for a mobile populace and increasing efficiency (Tiebout 1956; Oates and Schwab 1988; Kenyon 1997).

However, concern has increased about this competition for several reasons. First, its intensity has escalated greatly, injuring both winners and losers (Rivlin 1996). Then it could be a negative sum game, in which jurisdictions undersupply critical public goods to finance incentives for potential employers (Burstein and Rohnick 1996). Finally, it could become a race to the bottom in which the tactics used to attract economic development become self-defeating.

Fiscal competition for industry may be intensifying because of declining revenues and the limited tax tools available to localities. Globalization may also play a role, as localities are concerned about losing employment to overseas competitors. *Ad hoc* case studies seem to indicate an increasing occurrence of fiscal competition. In 1997, all 50 states reported that they had increased the level and variety of business-tax incentives over the past 20 years. Additionally, most of the states expected that they would have to increase the use of the incentives (Chi and Leatherby 1997). The value of incentives per projected job increase is also increasing: in 1980 Tennessee offered a package of incentives to Nissan worth about \$11,000 per job, while in 1993, Alabama offered Daimler Benz incentives worth about \$168,000 per promised job.<sup>23</sup> Tannenwald calculates that while the burden of state and local-personal taxes has risen, the burden of state and local corporate-income taxes has fallen by half – which may indicate that competitive concerns played a large role in cutting the corporate-tax burden.

It is worthwhile to question whether these incentives are actually being used to provide jobs or are they being used for other reasons (Chapman 2003b). For example, it may be that the jurisdiction is more interested in bolstering its revenues so that it can continue to provide enhanced-service levels. If this is the case, then jurisdictions will calculate the revenue gains versus the additional costs of serving the new development. If the expected net of subsidy gains exceed the service costs, then incentives make economic sense, regardless of the job gains.

It is also worthwhile to examine whether the use of public financial tools (PFT) as incentives for economic development actually work. After examining several dozen empirical studies, Wasylenko (1997) concluded that taxes have a small – but statistically significant – effect on interregional location (with an estimated interregional elasticity of about  $-0.2$ .) He also examined tax competition at the intra-regional level, where he found that tax elasticities were quadruple, or more than those found in interregional studies. Cities may be successful competitors with other cities in the same state by using these techniques, but states would find that incentives do not work well. He concluded cities and states should not use *ad hoc* tax changes, but rather suggested that systematic tax reform might be more beneficial. Other studies at the local level (Anderson and Wassmer 2000) concluded that while an outright ban on all local economic-development incentives in a

metropolitan area is not a preferred policy choice; a targeted use of local incentives by fiscally blighted communities is a worthwhile endeavor. Mark *et al.* (2000) examined Washington DC and found that sales and personal-property taxes reduced employment growth, while higher levels of non-welfare public-service expenditures increased employment growth.

Regardless of whether tax competition works, formal empirical studies indicate that it is occurring. Brueckner and Saavedra (2001) assumed a fixed supply of capital within a region and then developed a model reflecting a blend of the Tiebout and tax-competition traditions. Consumers are mobile and self-select into homogeneous communities with the homogeneity based on the consumer's demand for public goods. Once sorted, the residents choose property taxes, taking into account the concerns that higher taxes will lead to an outflow of capital. These property taxes are chosen strategically and are used to finance public goods. Because communities are concerned about capital flight, there is the tax-competition pressure toward under-provision of public goods. Using sophisticated econometric techniques, they found that strategic property-tax competition occurred in the Boston metropolitan area in 1980. The reaction curve is upward sloping – one community's best strategic response to an increase in property-tax rates of competing communities is to increase its own tax rate (which allows it to provide more of the public good).<sup>24</sup> Although strategic interactions were not found for residential rates in 1990, strategic interactions for business rates did exist.

Hernandez-Murillo (2003) also examines the prevalence of strategic interactions among states. Using the same model assumptions used before (competition for mobile capital, shoppers, firms, prevailing equilibrium-tax rate resulting in under-provision of public goods, and mobility away from high-tax jurisdiction), he finds that states have a positively sloped-reaction function to tax policies of rival states when tax rates are chosen simultaneously.<sup>25</sup> He calculates that an increase of 10 percent in the average of a state's rival-tax rates results in an increase of about 4.4 to 6.4 percent in a state's initial-tax rate, when border contiguity is used to determine rivalry. However, using economic regions as the basis for rivalry results in a much lower response rate, a 10 percent increase in the average regional rate generates a tax-rate increase of about 0.5 to 0.6 percent. He also finds that more populated states set higher rates and richer states have higher rates (but only when regions are considered), indicating that larger or richer jurisdictions have high-market power to tax local businesses.<sup>26</sup>

Esteller-Moré and Solé-Ollé (2002) examining Canadian provinces between 1982 and 1996 discovered that when the federal-tax rate was changed, provincial-tax rates also changed – a 1 percent increase in the federal-tax burden was followed by an approximate 0.20 percent increase in the provincial-tax burden. They also found that a 1 percent change in the competing provinces' tax rates (in this case, competing is defined as con-

tiguous) leads to a change in the tax rate of one province of 0.3 percent. Finally, Agostini (2003) has found that state governments, when utilizing multiple-tax instruments, trade-off tax rates. A 1 percent increase in the sales-tax rate is associated with a half and third percent decrease in the personal and corporate income-tax rates respectively. An increase in sales taxes is perhaps likely to compensate for decreasing the corporate-tax rate.

Some skepticism should be brought to bear on the interjurisdictional tax competition empirical analysis. It is safe to say there is some mobility of capital, but mostly within a region; that localities and states do seem to notice what other localities and states are doing; and probably some effects occur because of the tax system, principally the possibility of under-provision of local public goods. However, there are elements of “non-elegance” in these analyzes (Chapman 2003b). For example:

- The use of public financial tools can generate both positive and negative externalities and, perhaps, some moral-hazard concerns.
- Institutional arrangements vary among state and local jurisdictions and even among areas within local jurisdictions.
- Because of state and local politics, it is unlikely that the decision-making functions are smoothly differentiable and that all of the relevant second-order conditions are met.
- Local jurisdictions may be interested in maximizing land value and local fiscal surpluses.
- Local governments may not have enough autonomy to react fully and the empirical results should be interpreted as perhaps lower bounds.
- Income distribution and redistribution concerns, as well as rent-seeking behavior, may dwarf efficiency concerns.

These concerns need to be addressed when subnational-fiscal competition is analyzed in a federal system. Although some have argued that the central government should use its powers to restrain some of the egregious effects of this competition, many feel that replacement of the current system by a greater degree of central planning might slow economic growth. This would be extremely complex to administer, would not solve problems associated with competition from other countries and, in general, would create more problems than would be solved.

Tannenwald makes five recommendations: (1) To create more uniformity in taxes, there should be voluntary compacts among states to refrain from competition; (2) More information needs to be made available to the public, including reports of expected jobs, actual jobs, and wages to the new jobholders; (3) “Clawback” provisions should be implemented such that recipients of incentives must meet certain performance requirements or the public subsidy would have to be repaid; (4) The use of benefit-cost analysis for each of the projects should be increased, and (5) the corporate-

income tax should be abandoned. While these recommendations are unlikely to occur in the immediate future, they serve as normative goals for subnational interregional tax competition.

## **Section V: corruption and federalism**

Any debate over the reactions of subnational governments when resources become constrained in a federal system must note the possibility of corruption. The potential questions become whether subnational governments in a federal system are more corrupt than (1) they would be under a centralized system and (2) than the central government itself. There has been limited theoretical or empirical work on these issues. Bardhan and Mookherjee (2000), in a formal model, analyze the ability of dominant groups to capture government at different levels of government. They conclude that capture may be either greater or lower at the local than at the central level and, thus, empirical work needs to be done. Huther and Shah (1998) found that good governance is significantly correlated with particular indices of decentralization, although their work can be criticized because they use simple correlation. Fisman and Gatti (2002) found that fiscal decentralization is strongly and significantly associated with lower corruption, taking into account a system of governance variables. However, none of these studies included measures of hard- or soft-budget constraints.

Rodden, Eskeland, and Litvack argue that decentralization has the possibility of creating incentives for opportunistic behavior among state and local officials, especially if the incentive framework is not well established (see Davoodi and Zou 1988; Ebel and Yilmaz 2001, however, reach different conclusions). Most of the analysis assumes that a soft-budget constraint exists and the dependent variable is economic growth. They use this line of reasoning to argue against soft-budget constraints, which they believe leads to this opportunistic behavior. They conclude that decentralization cannot lead to efficiency gains through more responsive-resource allocation unless there is meaningful accountability. If accountability does not exist, a federal system may lead to corruption.

A series of National Bureau of Economic Research working papers examines the behavior of local schools (or school districts) in response to increasing mandates originating from higher levels of government.<sup>27</sup> These behaviors illustrate some unusual tactics as the districts attempted to increase student scores on standardized tests. For example, in one study, schools increased the caloric content of their lunches if they were fearful of low-test scores. They found that increasing calories improved 5th grade pass rates by 11, 6, and 6 percent respectively in mathematics, English, and history/social studies tests. They conclude that test-score gains may be artifacts of manipulation rather than improved efficiency (Figlio and Winicki 2003). Another paper found that schools attempted to “game the system”

by reclassifying some students as disabled and then putting them into special-education programs which were exempt from the state tests. There was a 50 percent higher rate of disability classification in the schools that were most likely to be on the margin of the state's accountability system (Figlio and Getzler 2003). Perhaps the worst case occurred in the Chicago School System, where it was found that systematic altering was done to student-test forms in 3 to 5 percent of the elementary classrooms in the sample (Jacob and Levitt 2003).

It may be that hard-budget constraints and increased expectations will lead to corrupt behavior. This implies that monitoring costs must increase, which may be a necessary part of the costs of a decentralized system.

## **Section VI: conclusions and recommendations**

Two basic lessons are apparent from this analysis. The first is that taxes should have some relationship to benefits at the subnational level. The second is that hard-budget constraints need to exist so that the tax/benefit relationship can be maintained. Other countries attempting to implement a successful intergovernmental system should take some lessons from how the US subnational governments deal with these constraints as their tax system continues to shift.

When a central government is vulnerable to manipulation by subnational governments, the best way to move to a hard-budget-constraint system in the short or intermediate run is for the central government to improve and clarify its role in overseeing the subnational governments (Rodden and Eskeland 2003). This central government involvement, however, must be based on clear, transparent rules. Once these rules are promulgated then, over time, there can be a movement to increase local-government autonomy, giving local governments the ability to manage their affairs. In the United States, citizens learned that the central government would not bail them out of fiscal difficulties and so they adjusted their state and local fiscal patterns to accommodate the hard-budget environment. This relationship must be made clear under subsidiarity regimes.

Even if the central government has a greater ability to collect revenues than subnational governments and there are transfers from the central to the subnational governments, this does not automatically mean that soft-budget constraints exist. Soft budgets come into being because it is known that the central government has discretionary ability to increase grants. Expectations exist, therefore, that the central government will exercise that ability to bail out the subnational governments. Thus, a decentralized federal system will work only if the central government's discretion is bounded – by either politics or legal constraints.

Rodden and Eskeland conclude that effective market discipline has many preconditions. Some relate to the political institutions that are

necessary to enable hard budgets to exist. The central government's vulnerability to pressure and its commitment to deny bailouts depends on its organization and incentive structure. If the legislative process gives authority to individuals or groups that have a national – not subnational – constituency for the overall economic performance of the country, then the ability to say “no” is increased. These groups can lead to a hierarchical set of rules that would enable the central government to resist these pressures (although this method seems to be unsuccessful in India and Brazil). These authors conclude that for a county to give its subnational jurisdictions more autonomy without softening budget constraints, a long run, general strategy has to be sustained. This strategy, that would use rules and administrative procedures to create the strongest possible incentives for voters, creditors and asset owners, to avoid getting into unbalanced budget situations, might increase central-government oversight in the short run and oversee local fiscal decisions in the end. This means that the central government's involvement should be non-discretionary and transparent. Horizontal delegation to independent central banks, the judiciary, and arbitrators might be quite valuable as the central government encourages market discipline. They conclude that accountability of all governments to their citizens is crucially important.

To put this theory into practice, there are several policy recommendations that might be useful in a federal system in which the revenue raising abilities of the subnational governments are declining. Often these policies involve trade-offs, which may make them difficult to implement.

One policy recommendation is to broaden the base for any particular tax, but especially sales tax. This base broadening would include a wider variety of services in taxable sales. This is administratively more feasible today than in the past because of improvements in technology that allow the tracking of service use and, if carefully implemented (for example, leaving out medical services that are involuntary), could promote neutrality between consumption of goods and consumption of services. On the other hand, taxation of business services would diminish tax neutrality by discriminating against industries that are heavily dependent on these services and might encourage a greater degree of vertical integration. It may be that since professional-service firms are likely to remain untaxed because of the potential political strength of these practitioners (typically lawyers and accountants), it is likely that much of the expansion of the service tax base will be on the personnel services provided by non-professionals. Since this is likely to be a competitive arena and since these services account for a larger proportion of the incomes of low-income and lower-middle-income households than the incomes of middle- and high-income households, the ultimate incidence of this base broadening might lead to an increase in the tax's regressivity.

A second policy designed for taxing e-commerce is to streamline sales-tax collections; for example, have a common base definition, which would allow easier tax collection. The trade-off here is a reduction in state and local tax autonomy, which can cause a strong political movement against streamlining. A voluntary national commission in the United States has been meeting for several years to attempt to help solve this problem and slow progress is being made.

In order to minimize the economic harm caused by the potential overuse of incentives for industrial/commercial relocation and development, the tax system must be configured so that the benefits of the commercial or industrial relocation are more equitably distributed. This is not as difficult as it sounds, since the data consistently indicate that fiscal incentives are far more important at the local level than at the state level. Mechanisms for tax-base sharing also must be implemented. The trade-off in this case is that competition is decreased and taxes might not be optimal.

Any federal system, over time, will see tax-base changes. It is better to determine beforehand the full onslaught of these changes and what the rules of the federalism game should be. It is easier to implement these rules when the system is first being determined than when it is fully functioning. In this implementation process, the voters must be informed fully so that when life becomes more difficult in the future, the political outrage will be less.

## Notes

- 1 Some argue the subsidiarity principle is rather empty, since its main purpose is to move the burden of proof to those member states that want stronger centralization. Additionally, there is no operational criterion that can be used to decide which government activities should be assigned to the center and which activities can be undertaken by individual member countries (Sinn 1994; Wellisch 2000).
- 2 There is also an argument that central governments have superior abilities in tax and service-delivery administration in developing countries (Bahl and Linn 1992: 388).
- 3 Rodden (2002) finds, in part, some similar results. In particular, when central governments are both constrained and take on heavy grant activity to subnational governments to ensure provision of public services, the central government is forced to commit to help the local governments.
- 4 McClure does not believe that benefit taxes would be adequate to finance government. Rather, he believes that a substantial amount of government services will have to be financed with taxes only loosely related to benefits (2001: 343).
- 5 These are general statements. For example, some states have no income tax, some have no sales tax; some cities have no property tax.
- 6 Income is measured by the taxpayer's consumption plus the change in net worth (Nelson and Cronin 2005).
- 7 Nearly every city/township government in Ohio and Pennsylvania uses an income or wage tax. However, nationally, this is still a small percentage, about



- 5 percent of city/township own source revenues and between 2 and 3 percent of local own source revenues.
- 8 In 2003, sales taxes provided 50 percent of state taxes (21 percent of total General Fund revenues) and 17 percent of local taxes (6 percent of total General Fund Revenue). (Chapman 2005).
  - 9 Wellisch, in his theoretical model, uses very small regions and implicitly assumes that these small regions are equivalent to local governments. For example, in his analysis of property tax incidence, he uses "local government" as a synonym for regions (p. 79).
  - 10 This assumes no positive spillover effects.
  - 11 Administrative problems, sometimes found in developing countries, will be ignored in this section.
  - 12 Two additional comments on the politics of this process are warranted. First, under the current law, the estate tax entirely disappears for a year and then is reinstated. This strange activity occurred to ensure that the total tax losses because of this action would be smaller than what the losses would be if the elimination continued. This elimination is unlikely to occur. Second, the terminology of the tax was changed during the political debate. The inheritance tax became known as the "death tax." Of course, no one argued for consistency and the income tax in the United States is still called the income tax, not the April 15th Tax (its lien date).
  - 13 If the state did decide to disconnect its specific tax from the federal tax, it would incur higher transaction costs for collection. These costs would have to be credited against the tax revenue gains that would occur from the disconnection.
  - 14 Intergovernmental grants and soft-/hard-budget constraints are discussed in Section IV.
  - 15 These concepts are useful for subnational governments. By definition, the central government, in a developed country, will face soft-budget constraints because it has some control of the supply of money and it has some control over the amount of debt it can issue (although in both cases, the central government may act as if it has more control than it really has). In the United States, there has been a movement to establish a Constitutional amendment to force a balanced federal budget. It has been supported by the politically conservative politicians, principally to force the national government into a hard-budget constraint. In lesser-developed countries, while there may be more control over the supply of money, international credit markets may constrain the amount of debt that can be issued. Then, the relevant constraints may be international sources of funds, such as the IMF and the World Bank.
  - 16 The soft-budget constraint also has been addressed in the context of a relationship between a private sector firm and its creditors. In this case, Maskin (1996: 125) defines it as arising "whenever a funding source finds it impossible to keep an enterprise to a fixed budget (i.e., whenever the enterprise can extract ex post a bigger subsidy or loan than would have been considered efficient ex ante.)"
  - 17 The following section heavily depends on the REL analysis.
  - 18 This is opposite the conclusion of REL, who argue that the key feature is that local governments do not have complete information about the odds of the central government paying off.
  - 19 Inman's particular point of view is that transfers offer an implicit subsidy to the local public sector for the purchase of local public goods. These transfers can be direct matching grants (price subsidies), in-kind services (such as federally financed infrastructure construction), or closed-end grants (targeted lump-sum

grants). His analysis explicitly leaves out positive spillover or externality effects, and thus deals with created inefficiencies. However, to the extent that there would be an under-provision of public services because of positive externalities not being recognized, there is a role for grants. Inman does not consider this situation.

- 20 While all local representatives might agree that a national policy favoring local cost shifting collectively is inefficient – that is, each local government gets its own subsidy but then must pay for the subsidies given to all the other local governments. No single local representative can unilaterally afford to sacrifice his own government’s subsidy for the benefits of an improved national policy.
- 21 In US political writing, the term “bail-out” is used much more casually than Inman uses it. For example, in one of California’s many fiscal crises, the state claimed to “bail-out” local government by changing the entire tax system. Inman’s bailout is defined by his three specific cost shift measures as described in the chapter.
- 22 The other two are: (1) an exogenous shift in production and consumption from goods and services and (2) the proliferation of electronic commerce.
- 23 Note that jobs are not guaranteed to go to the residents of the subsidizing jurisdiction.
- 24 The authors also found higher per capita tax bases, in well-off cities, allow public spending demands to be satisfied with lower tax rates. They also found that there is a strong demand for school spending in cities with a highly educated population which leads to higher rates, while the beneficial effect of growth on the tax base outstrips its effect on spending needs, thus permitting lower tax rates.
- 25 He also finds that state size has a positive effect on local tax rates.
- 26 These elasticities are quite small, ranging from about .04 to about .46.
- 27 School districts in the United States tend to be decentralized. Typically they are financed from local taxes; however, over the last 25 years, the state has played an increasing role in their financing. Over the last several years, however, the central government has increased its role in financing. With the increased financing often come increased expectations.

# 6

## Local Government Own-source Revenues and Debt Financing: Structure and Stress\*

*W. Bartley Hildreth*

Federalism enables local governments to differ in their fiscal policies, including the raising, spending and borrowing of money. These decisions involve political and economic perspectives involving multiple levels of government and different markets. This chapter uses comparative tax analysis to highlight the choices embedded in local fiscal autonomy.

Comparative tax research is at best a cautionary endeavor. Although sovereign governments may have similar domestic and international rights and responsibilities, they differ on their geopolitical aspirations and power. Their tax structures vary, as do their economic foundations. Moving below the central level to a subnational level opens up many variations in the scope of responsibility and the discretion in carrying out those duties. Accordingly, this chapter dissects the ingredients of local own-source revenue policy to advance the major question: "Which Federalism?"

One approach is to answer that major question based upon the experience of one established federal system. However, even narrowing the focus to American subnational governments does not escape the difficulty of making meaningful within country comparisons. For example, there are as many comparative rankings of state and local government tax policy as there are fiscal analysts. Studies by taxpayer groups, tax authorities, and independent analysts abound. One common approach is to rank tax burden based on tax collections in relation to population and income (e.g., Taylor 2004). The problem with this method is that it measures tax results, not the direct characteristics of the tax structure that are most subject to change by policy-makers. This approach is similar to judging education policy by an exclusive focus on per capita spending instead of the characteristics that interact to produce those results. If differences in tax structures matter, then ranking systems should reflect those differences. However, the other extreme is to provide numerous tables detailing differences without a summary measure (e.g., Advisory Commission on Intergovernmental Relations 1995). Accordingly, this chapter suggests a parsimonious method for ranking property and retail sales taxes that reflect strains on each tax structure. Although not

offered as a definitive approach, the goal of this approach is to offer insights into tax policy rankings within a federal form of government that enjoys large variations in tax structures.

The starting point for comparing tax policy is Adam Smith's (1776) four criteria for evaluating a tax. According to Adam Smith, subjects of the state should pay based on their ability, a measure of equity. Moreover, taxes should not unintentionally distort economic decisions. Tax administration should be efficient and, finally, the amount collected from the tax should be limited to only the amount needed.

Upon this foundation is built both the normative theory of optimal tax design and less formal methods of tax analysis. Alm (1996: 118) finds a schism "between those who work on the rarefied heights of optimal tax theory and those who toil in the trenches of practical tax design." Optimal tax design is "largely irrelevant" in tax policy practice because optimal theory ignores "relevant institutional features" that can lead to different tax policy trade-offs (Alm 1996: 118).

Tax structures, in fact, reflect an accumulation of political and economic decisions. Alt (1983) identifies five ways that tax structures can vary. The first way is by the level of revenues collected compared to the wealth base from which it is taken. The second method is the share of total revenues attributed to different taxes. Third, tax structures can vary by the extent of fragmentation of tax administration (centralization or decentralization). Fourth is the nature of redistribution achieved by the tax, with the incidence of the tax an issue. Fifth, Alt points to the complexity of a tax including the extent of tax expenditures.

Bird (1993) translates the issue of tax policy into one of fiscal decentralization. In drawing the distinction between central and local fiscal powers, Bird identifies four features of a "truly local" tax. Such a tax should be locally assessed, with rates set locally, and with revenues collected and budgeted locally. Such autonomy allows different communities to make different choices.

Government jurisdictions can use tax differences to compete for growth and development. The consumer/voter, in turn, can exploit these differences to satisfy a particular personal preference pattern (Tiebout 1956). However, tax structures can converge (Ashworth and Heyndels 2001). In fact, Annala (2003) provides evidence that American state and local tax policies have converged over time. His finding holds for total taxes as well as property and income taxes, but not the sales tax.

Federalism around the world is subject to different interpretations, various governmental frameworks, and diverse budget policies. Although countries can differ, there are three basic taxes to consider – income, consumption, and property. Therefore, the first section of this chapter compares local government tax sources in member countries of the Organization for Economic Co-operation and Development (OECD).

These results are compared to historical trends of local government finance in the United States.

Section two examines US local government property, sales and income tax structures. A review of the contemporary aspects of property and sales tax structures illustrate the forces that can strain the effectiveness of these taxes. Accordingly, this chapter introduces separate tax structure indexes for property and sales taxes. This design reflects the base, rate and yield features embodied in tax systems. One benefit is that it offers a way to observe the degree of policy convergence and tax design variation. More importantly, this research addresses the concluding point of Alt (1983: 215): "The simultaneous consideration of economic and political aspects of taxation can only improve future research."

Debt and taxes go together because both are sources of funding for public services and projects. However, there is a fundamental difference. Once a tax is levied by the governing body, taxpayers are obligated to pay if they engage in the taxed activity. In contrast, just because a governmental jurisdiction wants to borrow money, it does not mean that it will enjoy market access at an acceptable cost of capital. Therefore, acquiring money through the public capital markets depends upon the nature of the securities offered, the investors that are likely to purchase the securities, and the ability of the debt issuer to bring a successful offering to the market. To show that debt acquisition structures vary too, the third section of the chapter compares state and local borrowing in the US to provincial and municipal borrowing in Canada.

This chapter focuses on local taxation, specifically the use of property, income and sales taxes, and the acquisition of money through the capital markets. Although comparisons are made to other countries and higher levels in a federal system of government, American local governments remain the primary focus of attention.

## **LOCAL GOVERNMENT TAX SOURCES**

This section first compares the local tax mix in the 30 member countries of the OECD, and then examines local government tax trends in the United States. The focus is on income, sales and property taxes.

### **Local governments in OECD countries**

How balanced are local tax systems among property, sales and income taxes? A balanced tax system is defined as having none of the three primary taxes contribute more than 40 percent of revenues and no tax contributing less than 20 percent, whereas a more expansive definition of tax balance allows any of the three taxes to contribute as little as 15 percent of revenues or as much as 45 percent (Richardson and Hildreth 1999). Applying this concept to local governments in countries of the OECD (2006) reveals significant variability in own-source taxes (Kitchen

2002; OECD 2006). There is no country that meets the basic test of tax balance, although three countries – Japan, Spain, and Turkey – meet the broader measure, as reported in Table 6.1. Italy has balance between

**Table 6.1** Relative importance of local taxes in OECD countries, 2003

Countries	Tax source as a percentage of total local tax revenues				Local taxes as a percentage of gross domestic product (GDP)
	Income	Sales	Property	Other	
<b>Federal</b>					
Australia	0.00	0.00	100.00	0.00	0.94
Austria	56.65	27.68	10.45	5.21	4.04
Belgium	86.48	13.28	0.00	0.25	2.41
Canada	0.00	2.06	93.78	4.16	2.91
Germany	74.67	6.44	18.62	0.27	2.41
Mexico	0.05	1.49	84.56	13.90	0.19
Switzerland	83.30	0.30	16.40	0.00	4.78
United States	4.83	22.16	73.01	0.00	3.75
Unweighted Average	38.25	9.18	49.60	2.97	2.68
<b>Unitary</b>					
Czech Republic	56.50	39.53	3.97	0.01	4.78
Denmark	93.03	0.06	6.91	0.00	17.23
Finland	94.90	0.05	4.88	0.16	9.44
France	0.00	10.71	54.12	35.18	4.48
Greece	0.00	33.06	66.94	0.00	0.32
Hungary	0.36	74.81	24.55	0.28	2.22
Iceland	78.09	8.94	12.97	0.00	9.81
Ireland	0.00	0.00	100.00	0.00	0.62
Italy	22.15	22.84	15.06	39.95	7.28
Japan	45.17	21.61	32.18	1.03	6.51
Korea	13.77	19.73	51.53	14.98	4.57
Luxembourg	93.53	1.15	5.05	0.27	2.44
Netherlands	0.00	43.44	56.56	0.00	1.49
New Zealand	0.00	9.61	90.39	0.00	1.94
Norway	89.22	2.07	8.71	0.00	6.37
Poland	47.09	2.58	50.34	0.00	2.72
Portugal	22.51	47.69	25.32	4.47	2.16
Slovak Republic	51.65	24.37	21.92	2.06	1.58
Spain	24.34	48.38	26.00	1.28	9.84
Sweden	100.00	0.00	0.00	0.00	16.53
Turkey	32.45	42.76	18.83	5.96	1.90
United Kingdom	0.00	0.00	100.00	0.00	1.69
Unweighted Average	39.31	20.61	35.28	4.80	5.27

Source: Based on Kitchen (2002) with updated information from the Organization for Economic Co-Operation and Development (2006).

income, property and sales taxes, but the largest source is a fourth tax structure based on business.

Local income taxes accounted for more than 45 percent of local taxes in 14 of the 30 OECD countries (Austria, Belgium, Czech Republic, Denmark, Finland, Germany, Iceland, Japan, Luxembourg, Norway, Poland, Slovak Republic, Sweden, and Switzerland). In contrast, US local governments received 4.83 percent of their own-source taxes from the local income tax. The averages for the federal and unitary countries were approximately the same (38.25 percent and 39.31 percent, respectively).

The property tax accounted for more than a majority of local tax revenue in 12 countries (Australia, Canada, France, Greece, Ireland, Korea, Mexico, Netherlands, New Zealand, Poland, United Kingdom, and the United States). According to the OECD, local governments in the US received 73.01 percent from the property tax. The average for the 22 unitary countries was lower (at 35.28 percent) than the amount for the eight federal countries (49.60 percent).

Hungary is the only country with a majority (74.81 percent) of funding from sales taxes. In comparison, local governments in the US depended upon this source for 22.16 percent of 2003 tax receipts.

In 2000, Italy received 60.6 percent of local taxes from "other taxes...paid solely by business" (OECD 2002: 239). By 2003, however, Italy had moved toward a more diversified local government revenue system, with 39.95 percent of revenues from this "other taxes" category (OECD 2006: 226). Interestingly, sales taxes climbed from 8.6 percent in 2000 to 22.8 percent in 2003. These results suggest significant change in the Italian local government finance system that deserves more inquiry.

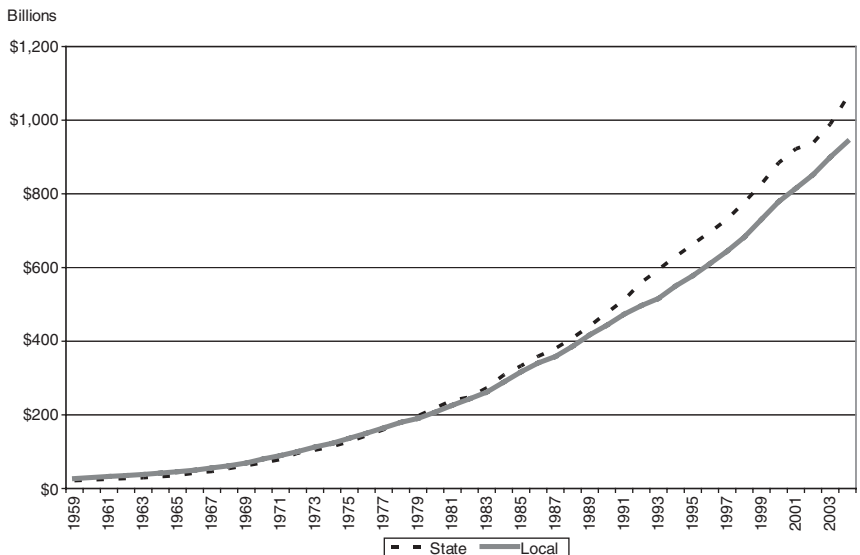
## **Local governments in the United States**

The US Constitution is silent on the subject of local governments. Therefore, these political jurisdictions are legally the creatures of their respective state governments. The result is 87,525 local governments in the United States, with the governing body of each jurisdiction enjoying some discretion in implementing that organization's mission. Within the 50 states are different local government types, including 3,034 counties, 19,429 municipalities and 16,504 towns or township governments (US Census Bureau 2000). In addition, there were 13,506 independent school districts and 35,052 special districts, such as port authorities, watershed districts, rural fire protection districts, and many other forms of single-purpose districts. Although they differ, each local governmental entity has a mix of taxing, spending and borrowing authority.

Local discretion also emanates from not having to obtain prior approval from a higher level of government for every fiscal decision. Yet, there are constraints. For example, the federal government, increasingly, asserts

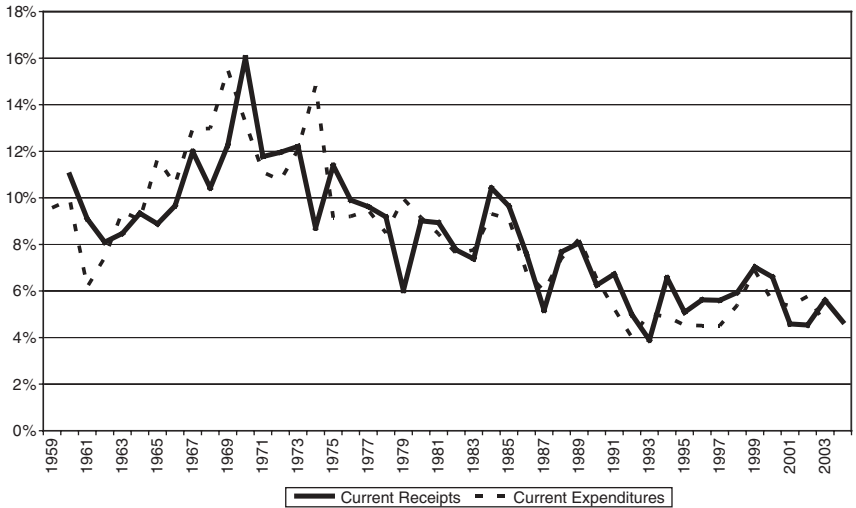
jurisdiction over certain fiscal matters, such as prohibiting the taxation of Internet access in the name of interstate commerce (an expansive door to federal preemption), or effectively precluding the taxation of remote sales as by mail-order, telephone, or sales conducted over the Internet. More frequently, the state government constrains local fiscal decisions with explicit prescriptions or proscriptions. In the form of mandates, these restrictions include outright bans on certain taxes; limits on the tax base, rate or yield; restrictions on the use of the money generated from a particular source of revenue; and/or, myriad other requirements effectively restricting discretion. For example, local officials may have an obligation to convey their decisions through such methods as publishing the adopted tax rate, sending the adopted budget and the end-of-year audited financial statement to a central state depository, or other perfunctory duties. These indirect mechanisms can frustrate local officials and add inefficiency to the fiscal decision process. Fiscal federalism does not expect absolute local autonomy.

On a National Income and Product Accounts (NIPA) basis, local governments collected \$26.9 billion in current receipts in 1959 compared to state government collections of \$21.8 billion (Figure 6.1).<sup>1</sup> The positions changed in 1981 when states collecting more revenues than all local governments. By 2004, local governments collected \$941.9 billion



*Figure 6.1* State and local government current receipts, NIPA basis, 1959–2004  
*Source:* Author's calculations based on data from the Bureau of Economic Analysis, US Department of Commerce.



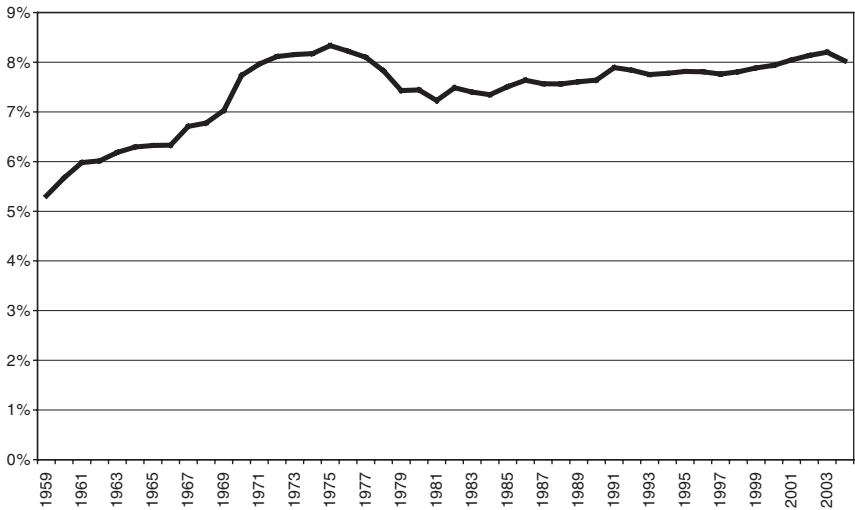


*Figure 6.2* Local government current receipts and expenditures, year over year change, NIPA basis, 1959–2004

*Source:* Author's calculations based on data from the Bureau of Economic Analysis, US Department of Commerce.

compared to \$1,062.5 billion by the states. Examining the data by yearly change, however, conveys a different story. Although the absolute percentage change of local government current receipts remains above 4 percent (see Figure 6.2), the yearly increase has softened considerably from significant levels of yearly increases in earlier decades. In comparison to current expenditures, there is a pronounced lag effect of large spending increases after large revenue increases. Whereas state revenues increased by only 1.78 percent from 2001 to 2002 (not shown here), the resilience of local governments to shocks such as 9-11 and the dot.com bust is illustrated by a local government revenue increase of 4.54 percent from 2001 to 2002. These trends are not adjusted for price changes because public budgets are not either; citizens are likely to react to reports of current dollar changes. These data offer a hint why citizens may have a concern about the size of, and growth of, (local) government.

Converting the series to a percent of GDP, as shown in Figure 6.3, reveals the significant decline in local government current receipts following the 1974 recession (highlighted by New York City's fiscal emergency of 1975) and a long period of recovery. More recently, the recent downturn reflects the post 9-11 environment. For example, New York City's personal income tax collections did not exceed the 2001 amount until 2005 (City of New



*Figure 6.3* Local government current receipts as percentage of GDP, NIPA basis, 1959–2004

*Source:* Author's calculations based on data from the Bureau of Economic Analysis, US Department of Commerce.

York 2005). Local governments, however, generally enjoy a healthy surplus position (Pagano 2002; Pagano and Hoene 2003), although some communities face significant fiscal problems. For example, in 2003, the City of Pittsburgh's bonds were downgraded to junk bond status after the city's external auditors warned that the city's viability was at risk without new revenue authority (Lucchetti 2003). On the other side of the country, San Diego's fiscal mismanagement continues to undermine its sunny façade (Wong 2004; San Diego Union Tribune 2006).

### Primary own-source revenues

State and local governments face a variety of revenue options, with taxes the most contentious ones in public debate. This section examines the structure of the property, income, and sales taxes (Carter and Hildreth 1992). The property tax remains the primary local revenue source for local governments, despite a decline in dependence over the last 40 years. In contrast, the sales tax has grown in use over the same period. Local income taxes remain a small segment of the overall fiscal picture of American local governments. Attention is roughly in proportion to their share of collections, as shown in Figure 6.4. A brief discussion of service charges concludes the section.

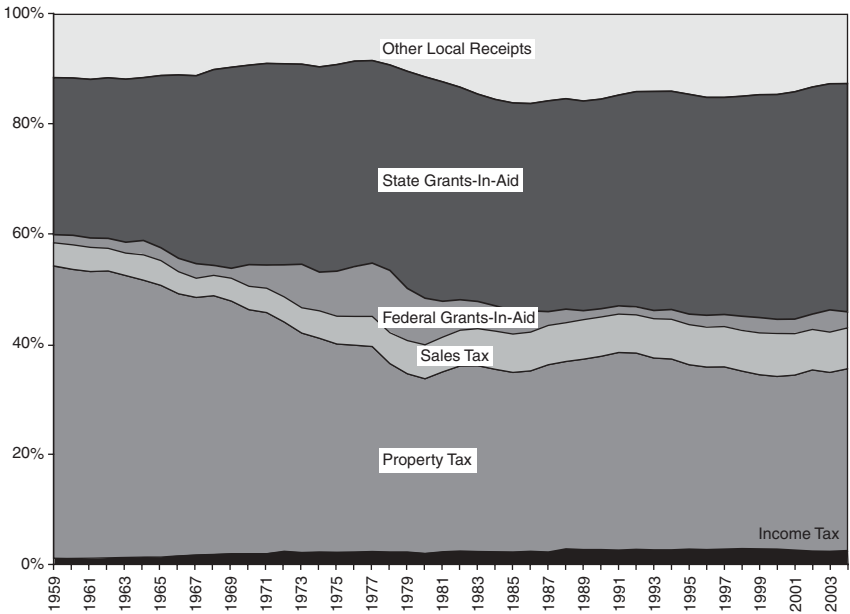


Figure 6.4 Local government sources of funds as percentage of total, NIPA basis, 1959–2004

Source: Author's calculations based on data from the Bureau of Economic Analysis, US Department of Commerce.

## Property tax

Glenn Fisher's (1996) sweeping history of the property tax in America traces the shifting political and economic support for equality of taxation. A shift from uniformity as a single rule of tax design to multiple rules reflects political responsiveness. Fisher finds the 19<sup>th</sup> century a period of uniformity, a symbol of equality. Property taxation encompassed real and personal property, tangible and intangible, all in proportion to value. Everyone was taxed, both the powerful and the politically weak. Accordingly, the tax was viewed as simple and fair, and easy to administer locally.

A retreat from the uniformity principle occurred at the turn of the 20<sup>th</sup> century with the mobility of people and the complexity of commerce. Voluntary compliance dropped, and locally elected assessors increasingly were prone to making exceptions despite laws to the contrary. These local decisions imperiled state budgets dependent upon the locally administered property tax. In addition, a rising sentiment that intangibles were subject to double taxation led to a movement to exempt that class of assets from the broad-based property tax. All of these factors, plus the Great Depression, con-

tributed to states finding refuge in the taxation of income and retail sales, leaving property primarily taxed locally. The one exception to states retreating from uniformity was the movement to centralize taxation of rate-regulated railroads and utilities, both to protect that industry segment from local officials who might succumb to overtaxing out-of-town businesses and a more positive perspective that central administration was best for network utilities.

Fisher finds the modern property tax especially responsive to the political process and economic arguments, illustrated by a long, and growing, list of deviations from a uniform base. For example, homestead exemptions remove residential property from the tax rolls, use-value taxation protects agricultural property from valuation increases caused by adjacent development, and industrial tax exemptions remove targeted businesses from the tax list. Other exemptions spring forth almost yearly from nearly every state legislature. Fisher links this trend of tax personalization with the growth of voter discontent exemplified by various forms of tax and expenditure limits.

### Contemporary aspects of the property tax structure

Local governments still depend upon the property tax. The tax provides current operating revenues and is leveraged through debt financing to cover the acquisition and construction of capital assets and infrastructure. Therefore, the share of revenues generated by the property tax provides a measure of dependence on this source of funds. In 2002, local governments received 45 percent of own-source general revenue from the property tax, as reported in Table 6.2. School districts relied on the tax for almost

**Table 6.2** Property tax in local government finance by type of government unit, 2002

Type of government	Property tax (\$ in millions)	Own-source general revenue (\$ in millions)	Property tax as a percentage of own-source general revenue
All Local Governments	\$269,489	\$597,139	45.13%
School Districts	\$119,970	\$151,249	79.32%
General-purpose Governments	\$139,196	\$384,359	36.22%
Special Districts	\$10,254	\$61,751	16.61%
Counties 250,000+ population	\$37,469	\$93,687	39.99%
Municipalities 200,000+ population	\$24,653	\$95,314	25.87%

Source: Based on Netzer (2003a) with updated information from Census of Governments, 2002, US Bureau of Census.

80 percent of own-source general revenues whereas for general-purpose local governments it was 36 percent. Showing their limited reliance on this tax, special district governments received 17 percent of own-source general revenues from the property tax. Large counties (defined as 250,000 or higher in population) received 40 percent of own-source general revenues from the property tax compared to 26 percent for large municipalities (defined as those with a population of 200,000 or higher). Similar calculations using 1997 data, the last prior data collection period, found similar results except that large counties relied more on the property tax then (45 percent) than in 2002 (40 percent). Although some state governments use the property tax, the aggregate amount is less than two percent of total taxes, an amount that could be understated due to the classification in some states of a state-wide mandated school property tax as a local tax whereas in other states the same mechanism is classified as a state tax (Kenyon 2003).

The property tax is called the *ad valorem* tax because the concept is to set taxable value according to physical value. Determining this physical value is the point that bothers many taxpayers. The income tax appears to have a clear tax base although the sales tax rate is applied against the market price of the taxable commodity or service. Short of an exchange in the market place to determine the market value, however, a property's value depends on a subjective evaluation that is open to dispute. Especially challenging the tax assessor's ability to assign an appropriate "market" value to such a property is when there are few trades of similar properties, as is the case in rural areas and small towns. Access to business-specific valuation guides and computerized data from other jurisdictions around the state can help these local assessors deal with this information deficiency. Solving this problem can lead to other problems. California's Proposition 13, for example, was fueled by taxpayer shock to an efficient valuation process. The horizontal equity problem with that famous citizen initiative was addressed by the US Supreme Court, in *Nordlinger v. Hahn* (505 US 1, 1992). The Court upheld California's "welcome neighbor" approach to assessment inequity that permits long-term residents to enjoy lower effective tax rates compared to owners of newly purchased properties (Sexton *et al.* 1999).

Proposition 13 is not the only situation that leads to tax inequity. In another common area, many states classify real property into categories such as residential, commercial, agricultural, and public utility, and in the process use different weighting schemes for each. For example, Kansas assesses residential property at 11.5 cents for every dollar of (estimated) market value, commercial property at 25 cents on the dollar and public utility property at 33 cents on the dollar. This arbitrary classification scheme violates tax fairness. Electric industry restructuring was delayed in several states until fiscal transition rules could be created to solve the

problem caused by similar inequities in taxation. Commonly, a privately owned (merchant) power plant could be taxed at the lower commercial property value although a power plant owned by an integrated electric utility would be taxed on a unity basis, by the state, as part of the entire utility instead of the physical value of the single power plant (Seaman and Hildreth 2003). In another example, erosion of the tax base due to charity and non-profit exemptions have prompted communities to call for payments-in-lieu of taxes, if not reconsideration of the exemption altogether (Brody 2002).

An especially troubling exemption is termed the “homestead exemption.” This reduction in tax base rewards home ownership, often stated as a dollar amount reduction of taxable value. In Louisiana, for example, the effect is to exempt the first \$75,000 of market value on a homestead from taxation. Since homeowners vote, this tax exemption resists any reduction, thereby rendering higher rates on the commercial and industrial properties – an anti-business tax of the first magnitude – which, of course, do not have the power to vote. This type of disparate treatment of commercial property relative to residential leads to different effective tax rates.

Property tax assessment is decentralized and fragmented. Although municipalities in some states have this responsibility, counties are the primary level where this administrative responsibility resides (Behrens 1998: 245). One very unusual setting is Orleans parish (county), Louisiana – the location of the City of New Orleans – where there are seven assessors elected by district.<sup>2</sup> There are substantial economies of scale in performing property tax assessments even when there is only one assessor per county. Sjoquist and Walker (1999) report cost savings in the magnitude of 20 percent from consolidating assessment functions in 68 smaller Georgia counties. In a study of Illinois counties, Giertz and Chicoine (1990) draw similar conclusions on the advantages of consolidating assessing jurisdictions. These results confirm the earlier recommendations on centralized assessment by the Advisory Commission on Intergovernmental Relations (1963).

Citizens dislike a government entity that does not temper its use of the taxing power. In lieu, or instead, of public officials addressing the matter, citizens turn to various mechanisms to exert control (Mullins 2003). Limits on the tax base can take the form of caps on the growth of the base. The tax rate can be limited by requiring citizens to vote on changes to the rate, as in a supermajority of citizens voting. Even the yield can be limited by restricting the amount that can be collected, as in the prior year’s levy adjusted for inflation. Evidence is accumulating that property tax limitations have beneficial results in controlling the Leviathan model of government (McGuire 1999). Other implications include increased centralization of resources and budgetary decision-making at the state

level, increased use of service charges and other forms of non-tax local sources, and a lessening of ability to respond to local service preferences (Mullins and Joyce 1996).

### **Property tax structure index**

This review of the contemporary aspects of the property tax structure illustrates the forces that can strain its effectiveness. Tax design, therefore, reflects tension on the structure. The local property tax policy structure index was constructed using four equally weighted factors to gauge the variation across the states.

*Complexity.* The number of counties in each state, as reported by the Census Bureau, provides a convenient measure of the administrative assignment of this tax, although in some states property tax administration may reside at the municipal level. The results are normalized by the mean of the series. This method neutralizes the scaling differences in this and other factors, thereby permitting the four factors to be added together to generate the overall index.

*Adequacy.* In a narrow view of efficiency, for a government to be dependent on one tax source subjects it to the vicissitudes of economic and political forces arrayed against that particular source of funding and the distorting effects that can arise. Therefore, the percentage of state and local property tax collections to total state and local taxes provides a measure of the level of dependency on this tax source (using Census Bureau data for 1997). The purpose of including state property tax receipts is to avoid the problems caused by the peculiar assignment of state-wide school property taxes to a type of government (Kenyon 2003). Even if there is a state property tax, administration remains at the local level (except, perhaps, for regulated public utility property). The results are normed by the mean of the series.

*Equity.* One measure of tax equity is the relationship between effective tax rates for commercial to residential properties in metropolitan areas of each state, as reported by Mullins (2003) for 1996–98. The results are normed by the mean of the series.

*Constraint.* Although there are many different forms of tax limits – limits on rates, base and yield – the one that imposes limits on the tax base, specifically on assessment increases, has proven the most troublesome for tax administration and equity concerns, as embodied by the “welcome neighbor” effect in California. This dichotomous measure is coded 1 if the constraint exists, and 0 if not (based on data from International Association of Assessing Officials 2000; Mullins 2003).

States are arrayed according to the local property tax structure index in Figure 6.5. With a national mean of 3.32, the Texas index of 7.2 is 2.17 times the national mean. The four states with the highest index (greater than 1.5 times the mean) are Texas, Illinois, New York and

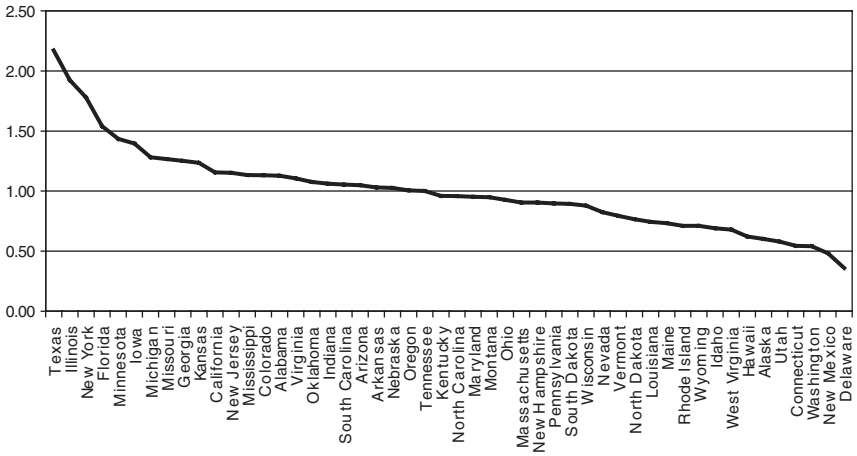


Figure 6.5 Property tax structure index

Source: Author's calculations.

Florida. An examination of each of the factors of the index (see Table 6.3) reveals that Texas has a significantly higher number of counties than the other states, relies on the property tax for 38 percent of total state and local taxes, imposes a slightly higher effective tax rate on commercial properties than on residential properties, and copes with an assessment limitation. Illinois, New York, Florida and Minnesota impose significantly higher effective tax rates on commercial compared to residential properties, although having a heavy dependence on this tax source. At the opposite end of the index are states that generally have a low reliance on the property tax, higher residential effective tax rates compared to commercial properties, fewer counties, and no limits on assessed value increases.

The value of this index is that it provides a policy portfolio perspective to tax policy. As an exploratory effort, this index (and the following one for the sales tax) is not intended as a definitive index. Kelly (2000a, 2000b) posits an alternative conceptual model for determining the effectiveness of a property tax system. His model requires data on coverage, valuation, burden, and collection that are not easily found for each jurisdiction. Therefore, the current index lays the groundwork for future research. A desirable outcome of this (and similar) efforts would be to generate an overall way of evaluating the political and economic decisions involved in the tax structure. Such a perspective could add to the discussion about property tax reforms and the use of this tax relative to others (McGuire 2000; Netzer 2003a, 2003b).



**Table 6.3** Property tax structure index by state

State	Number of counties	Counties normed	State & local property tax to total state & local taxes	Share normed	Ratio commerial to residential effective property tax rate	Rate normed	Limits on increases of assessed value: 1 = yes, 0 = no	Index	Index normed
Texas	254	4.17	0.38	1.28	1.05	0.76	1	7.21	2.17
Illinois	102	1.68	0.38	1.29	3.36	2.42	1	6.39	1.92
New York	57	0.94	0.32	1.09	4.00	2.88	1	5.91	1.78
Florida	66	1.08	0.35	1.18	2.56	1.85	1	5.11	1.54
Minnesota	87	1.43	0.27	0.93	3.34	2.40	0	4.76	1.43
Iowa	99	1.63	0.32	1.10	1.26	0.90	1	4.63	1.39
Michigan	83	1.36	0.29	0.99	1.25	0.90	1	4.25	1.28
Missouri	114	1.87	0.22	0.76	2.18	1.57	0	4.20	1.27
Georgia	156	2.56	0.27	0.93	0.92	0.67	0	4.16	1.25
Kansas	105	1.73	0.31	1.05	1.83	1.32	0	4.10	1.23
California	57	0.94	0.26	0.87	1.42	1.03	1	3.84	1.16
New Jersey	21	0.35	0.47	1.59	1.24	0.89	1	3.83	1.15
Mississippi	82	1.35	0.23	0.80	2.24	1.62	0	3.76	1.13
Colorado	62	1.02	0.29	1.00	2.41	1.74	0	3.76	1.13
Alabama	67	1.10	0.13	0.44	1.67	1.20	1	3.75	1.13
Virginia	95	1.56	0.31	1.06	1.45	1.04	0	3.67	1.11
Oklahoma	77	1.27	0.15	0.52	1.09	0.78	1	3.57	1.08
Indiana	91	1.50	0.35	1.18	1.18	0.85	0	3.53	1.06
South Carolina	46	0.76	0.27	0.92	1.15	0.83	1	3.50	1.06
Arizona	15	0.25	0.29	0.98	1.75	1.26	1	3.48	1.05
Arkansas	75	1.23	0.16	0.54	0.90	0.65	1	3.42	1.03
Nebraska	93	1.53	0.35	1.21	0.93	0.67	0	3.41	1.03
Oregon	36	0.59	0.31	1.07	0.94	0.68	1	3.34	1.01
Tennessee	93	1.53	0.22	0.75	1.45	1.04	0	3.32	1.00
Kentucky	119	1.96	0.17	0.59	0.90	0.65	0	3.19	0.96
North Carolina	100	1.64	0.21	0.73	1.12	0.81	0	3.18	0.96
Maryland	23	0.38	0.26	0.88	1.25	0.90	1	3.16	0.95
Montana	54	0.89	0.43	1.46	1.12	0.80	0	3.15	0.95
Ohio	88	1.45	0.29	0.98	0.90	0.65	0	3.08	0.93
Massachusetts	12	0.20	0.33	1.12	2.34	1.68	0	3.00	0.90
New Hampshire	10	0.16	0.66	2.25	0.81	0.59	0	3.00	0.90
Pennsylvania	66	1.08	0.28	0.96	1.29	0.93	0	2.98	0.90
South Dakota	66	1.08	0.36	1.24	0.89	0.64	0	2.97	0.89
Wisconsin	72	1.18	0.33	1.14	0.83	0.60	0	2.92	0.88
Nevada	16	0.26	0.22	0.75	1.02	0.73	1	2.74	0.83
Vermont	14	0.23	0.45	1.52	1.22	0.88	0	2.63	0.79
North Dakota	53	0.87	0.29	1.00	0.93	0.67	0	2.54	0.77
Louisiana	60	0.99	0.15	0.51	1.35	0.97	0	2.47	0.74
Maine	16	0.26	0.43	1.46	0.99	0.71	0	2.43	0.73
Rhode Island	0	0.00	0.42	1.43	1.30	0.93	0	2.36	0.71
Wyoming	23	0.38	0.37	1.28	0.98	0.70	0	2.36	0.71

**Table 6.3** Property tax structure index by state – *continued*

State	Number of counties	Counties normed	State & local property tax to total state & local taxes	Share normed	Ratio commerial to residential effective property tax rate	Rate normed	Limits on increases of assessed value: 1 = yes, 0 = no	Index	Index normed
Idaho	44	0.72	0.26	0.89	0.94	0.68	0	2.29	0.69
West Virginia	55	0.90	0.20	0.68	0.93	0.67	0	2.25	0.68
Hawaii	3	0.05	0.16	0.54	2.06	1.48	0	2.07	0.62
Alaska	12	0.20	0.29	0.97	1.15	0.83	0	2.00	0.60
Utah	29	0.48	0.23	0.80	0.90	0.65	0	1.93	0.58
Connecticut	0	0.00	0.36	1.22	0.82	0.59	0	1.81	0.54
Washington	39	0.64	0.32	1.09	0.10	0.07	0	1.80	0.54
New Mexico	33	0.54	0.12	0.42	0.88	0.63	0	1.60	0.48
Delaware	3	0.05	0.16	0.54	0.84	0.60	0	1.19	0.36
	60.86		0.29		1.39			3.32	1.00

*Source:* Author's calculations based on number of counties and tax shares (1997 Census of Governments), tax rates (Mullins 2003) and limits (IAAO 2003 and Mullins 2003).

## Sales tax

The Great Depression led the State of Mississippi to introduce the first retail sales tax to offset the loss of property tax revenue, and within six years 26 other states had adopted this innovative tax (Mikesell 1997; Fox 1997). Since then, all but five states have adopted the retail sales tax to support their budgets. Within limits, most states have authorized their local governments to impose a sales tax. In an example of fiscal federalism, Alaska does not levy a state sales tax but it permits its local governments to impose the tax. This section, therefore, examines basic characteristics about the retail sales tax used by local governments (Due and Mikesell 1994). Excluded from this discussion are excise taxes on particular commodities such as alcoholic beverages, tobacco products, motor fuel, or regulated public utilities.

### Contemporary aspects of the sales tax structure

As illustrated earlier in Figure 6.4, American local governments rely on the sales tax for less than 8 percent of current receipts, but reliance grows. This dependence varies by state and by type of government, with municipalities more reliant on the local option sales tax than counties (McGuire 2000).

As designed, the sales tax is applied on retail sales of goods and services. However, states often exempt food, pharmaceutical products, and most services (e.g., legal, accounting, and advertising) from the tax. The incentive for governments, then, is to recruit “big box” retailers or destination stores – such as Wal-Mart, AutoNation, and Cabela’s – to locate in their community in order to gain the retail sales generated by these large retailers.

Ease of administration arises by having the retailer collect the tax and remit collections to the tax administrator. To avoid consumers shopping outside the taxing area, a “use” tax accompanies the “sales” tax (used interchangeably here), thereby making the consumer liable for the amount of tax that otherwise would have been imposed.

Most states require local governments to piggyback on the state sales tax, thereby achieving base uniformity and one central tax administration. State and local officials lament the erosion of the tax base due to Internet sales and other remote vendor sales, but their cry for legislative relief from Congress has fallen short of their quest to overturn the US Supreme Court case of *Quill Corp. v. North Dakota* (504 US 298, 1992). In that case, the Supreme Court ruled that North Dakota could only require businesses to collect the sales tax that had a “substantial nexus” with the state.

Given the amount of sales conducted over the Internet, much less by telephone and mail, many states have entered into an interstate compact agreement to simplify the sales and use tax structures. Participating states in the Streamlined Sales Tax Project have modified their sales and use taxes to make the tax easy for remote retailers to instantly, electronically determine if an item is taxed at the destination site, and, if so, the rate and jurisdiction to whom remittance is due. The longer-term goal of the streamlining project is to win Congressional action requiring remote vendors to collect and remit the appropriate use tax amount, or, short of that, to win Supreme Court reconsideration of its prior holding, which was premised, in part, on the complexity of the retail sales tax around the country (Reese 2003).

Without having the retailer serve as the collector, tax administrators are left hoping that consumers will voluntarily report their mail order or e-commerce purchases and remit the use tax on such purchases. Few consumers comply, except for the purchase of automotive vehicles where there is a registration process that can serve as a point of discovery and collection of the tax.

Given that most state governments rely on the sales tax to finance their own budgets, states place limits on the rates that can be imposed by their local governments. This barrier is often expressed as a local option tax, meaning it is not a mandatory tax but up to local citizens to impose the local tax, but only up to the allowed rate. Consumers, however, are unlikely to focus on the assigned rate for a particular jurisdiction because

the tax on the purchase price of a taxed commodity or service is the combined state and local tax rate.

### Sales tax structure index

Local government retail sales taxes have a strong state orientation because most states require the local sales tax to be based on the same taxable items as the state tax, and the tax collected by the state with receipts (often minus an administrative fee) remitted back to the taxing jurisdiction. Moreover, state tax rates are constrained by the existence of local sales tax rates since it is the combined tax rate that the consumer pays. Accordingly, the sales tax structure index uses three equally weighted factors.

*Tax base.* A broad-based retail sales tax includes services, groceries, clothing, pharmaceutical products, and intangible items, compared to a narrow base excluding most, if not all, of these items. Although a few states permit their local governments to deviate from the state sales tax base in one or more ways, for our purposes we treat them the same. Mikesell (2000) presents an estimate of the implicit sales tax base for each state in 1998 as a percent of state personal income. This measure is then normed by the mean of the series.

*Tax rate.* Given that consumers pay the combined state and local sales tax rate, this factor uses the maximum state and local tax rate (Federation of Tax Administrators 2003). The results are normed by the mean of the series.

*Adequacy.* Dependency on a single tax source renders the jurisdiction vulnerable to shifts in economic and political forces that could endanger the budget. Because local sales taxes are tied so closely to state sales taxes, the measure used here is the share of state and local sales tax collections to total state and local tax receipts (based on Census Bureau data for 1997). The results are normed by the mean of the series.

States with a state sales tax are arrayed according to the normalized index in Figure 6.6. There is more convergence on the sales tax index than on the property tax index, although states at the higher end generally rely on a broader base, have higher tax rates and depend on this tax more than those at the opposite end of the index (as revealed by the details in Table 6.4). New Mexico and Hawaii have particularly broad sales taxes because they tax a range of consumer services, unlike most other state sales taxes. Alabama has the highest maximum sales tax rate but a relatively narrow tax base, so it is more dependent on this tax than the average state. Louisiana and Tennessee, in contrast, have relatively high combined tax rates on broader bases, yielding even more dependency. At the lower end of the index, states have relative lower tax rates, narrower tax bases, and lower reliance on the tax. Not included in the chart are four states – Delaware, Montana, New Hampshire and Oregon – without a state sales tax although

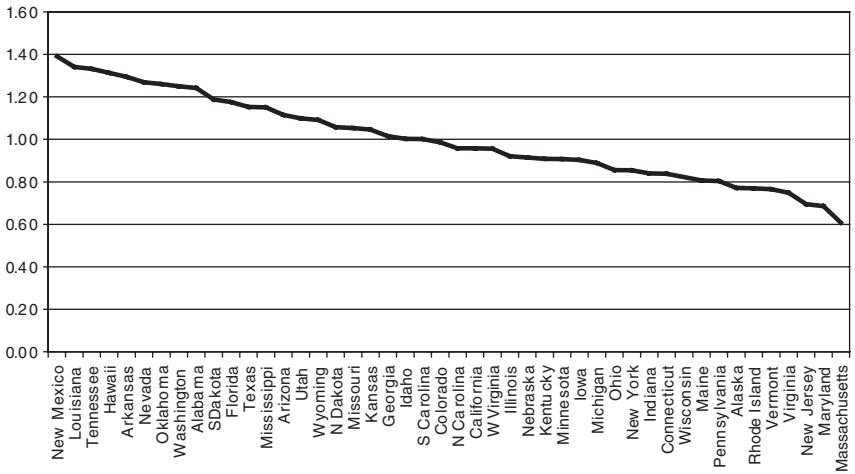


Figure 6.6 Sales tax structure index  
 Source: Author's calculations.

Table 6.4 Sales tax structure index by state

State	Maximum state & local tax rate	Rate normed	Implicit sales tax base to personal income	Base normed	State & local sales tax to total state & local taxes	Share normed	Index	Index normed
New Mexico	7.25	1.00	0.89	1.80	0.52	1.37	4.17	1.39
Louisiana	9.50	1.31	0.64	1.28	0.54	1.42	4.02	1.34
Tennessee	9.75	1.35	0.52	1.06	0.60	1.59	3.99	1.33
Hawaii	4.00	0.55	1.01	2.04	0.51	1.34	3.94	1.31
Arkansas	9.88	1.37	0.63	1.28	0.47	1.24	3.88	1.29
Nevada	7.25	1.00	0.57	1.15	0.63	1.65	3.80	1.27
Oklahoma	9.85	1.36	0.67	1.36	0.40	1.06	3.78	1.26
Washington	8.90	1.23	0.48	0.97	0.59	1.55	3.75	1.25
Alabama	11.00	1.52	0.43	0.87	0.51	1.33	3.72	1.24
S Dakota	6.00	0.83	0.69	1.39	0.51	1.34	3.56	1.19
Florida	7.50	1.04	0.56	1.12	0.52	1.36	3.53	1.18
Texas	8.25	1.14	0.49	0.98	0.51	1.34	3.46	1.15
Mississippi	7.25	1.00	0.56	1.12	0.50	1.33	3.45	1.15
Arizona	8.60	1.19	0.47	0.95	0.46	1.20	3.35	1.12
Utah	7.00	0.97	0.61	1.23	0.42	1.10	3.30	1.10
Wyoming	6.00	0.83	0.75	1.52	0.35	0.93	3.27	1.09
N Dakota	7.50	1.04	0.53	1.07	0.41	1.07	3.17	1.06
Missouri	8.35	1.16	0.47	0.94	0.40	1.06	3.16	1.05

**Table 6.4** Sales Tax Structure Index by State – *continued*

State	Maximum state & local tax rate	Rate normed	Implicit sales tax base to personal income	Base normed	State & local sales tax to total state & local taxes	Share normed	Index	Index normed
Kansas	8.30	1.15	0.50	1.01	0.37	0.98	3.14	1.05
Georgia	7.00	0.97	0.52	1.04	0.39	1.03	3.05	1.02
Idaho	8.00	1.11	0.50	1.02	0.34	0.88	3.01	1.00
S Carolina	7.00	0.97	0.53	1.07	0.37	0.96	3.00	1.00
Colorado	7.90	1.09	0.45	0.90	0.37	0.96	2.96	0.99
N Carolina	7.50	1.04	0.45	0.91	0.35	0.93	2.87	0.96
California	8.50	1.18	0.39	0.80	0.34	0.90	2.87	0.96
West Virginia	6.00	0.83	0.49	0.98	0.40	1.06	2.87	0.96
Illinois	9.25	1.28	0.32	0.64	0.32	0.84	2.76	0.92
Nebraska	7.00	0.97	0.44	0.90	0.33	0.88	2.74	0.91
Kentucky	6.00	0.83	0.46	0.93	0.37	0.96	2.72	0.91
Minnesota	7.50	1.04	0.44	0.88	0.31	0.81	2.72	0.91
Iowa	7.00	0.97	0.45	0.90	0.32	0.84	2.71	0.90
Michigan	6.00	0.83	0.50	1.01	0.31	0.82	2.67	0.89
Ohio	7.00	0.97	0.39	0.79	0.31	0.81	2.57	0.86
New York	8.50	1.18	0.34	0.69	0.26	0.69	2.56	0.85
Indiana	6.00	0.83	0.44	0.89	0.30	0.80	2.52	0.84
Connecticut	6.00	0.83	0.41	0.83	0.33	0.86	2.51	0.84
Wisconsin	5.60	0.78	0.46	0.93	0.29	0.76	2.47	0.82
Maine	5.00	0.69	0.48	0.98	0.29	0.75	2.42	0.81
Pennsylvania	7.00	0.97	0.33	0.66	0.30	0.78	2.41	0.80
Alaska	7.00	0.97	0.50	1.00	0.13	0.35	2.31	0.77
Rhode Island	7.00	0.97	0.28	0.57	0.29	0.77	2.31	0.77
Vermont	6.00	0.83	0.40	0.81	0.25	0.65	2.30	0.77
Virginia	4.50	0.62	0.42	0.85	0.29	0.77	2.25	0.75
New Jersey	6.00	0.83	0.29	0.58	0.26	0.67	2.08	0.69
Maryland	5.00	0.69	0.35	0.70	0.25	0.67	2.06	0.69
Massachusetts	5.00	0.69	0.29	0.59	0.21	0.54	1.82	0.61
	7.23		0.50		0.38		3.00	

*Note:* Alaska does not have a state sales tax but local governments can impose the tax. The base is assumed to be the mean of the series.

*Source:* Author's calculations based on tax rates from Federation of Tax Administrators (2003), base from Mikesell (2000) and shares (Bureau of the Census 1997–98).

the Census reports some sales-related tax collections. In addition, Alaska does not have a state sales tax but it does permit local sales taxes.

Mikesell (2005) offers an alternative way to grade the state sales tax structure after acknowledging that it involves many judgments. In constructing

his state government sales tax “quality index,” Mikesell codes tax base and tax rate characteristics by category and unique weights. Moreover, Mikesell’s index does not incorporate features of adequacy, as suggested by Adam Smith (1776) and Alt (1983). Although Mikesell’s results for state governments differ from those reported here for local governments, it is instructive to recognize that “(t)here is no uniform structural definition of the U.S. retail sales tax” (Mikesell 2005: 135). Both the current effort and Mikesell’s rating scheme rest on the following cautious advice: “It is possible to have different evaluations..., but an effort is made to provide a degree of process transparency so that those with differing standards can create their own measure” (Mikesell 2005: 132).

### **Income tax**

Few local governments in America enjoy the ability to levy a local income tax, consistent with the results shown in Figure 6.4. At least ten states allow a local income tax of some type (it may be termed an occupational tax defined as a tax on wages, or the net income of business). The most frequent use of the local income tax is found in Pennsylvania municipalities and Ohio municipalities. Other states bestow special taxing authority to particular jurisdictions, such as particular cities in Alabama and Missouri, and school districts in Iowa and Ohio.

Given its low utilization around the country, the brief focus here is on key characteristics in the design of the local income tax. The simplicity principle of taxation is violated when local governments administer their own income taxes. Electric industry restructuring in Ohio, for example, was delayed until an agreement was reached that made it easier for firms desiring to enter the retail electricity market to use a uniform municipal income tax form and to rely on a central webpage for links to each particular jurisdiction’s locally administered corporate income rules and instructions (Seaman and Hildreth 2003). This simple reform advanced the transparency of the tax not only for this segment but all multi-state firms doing business in Ohio local communities.

An alternative administrative approach is for the local income tax to be piggybacked on the state income tax. The loss of local administration is offset by the state’s broader tax base. That is because, unlike most states that link their tax to the federal government’s broad definition of taxable income, most local government income taxes are on enumerated forms of earned income, such as wages, salaries, tips, and commissions. Such a narrow base violates the equity principle by excluding non-earned sources, such as interest, rents, royalties, capital gains, and inheritance. Moreover, a local income tax is more likely to tax proprietary income (from unincorporated business and professional activities) instead of corporate income, therefore distorting business tax policy.

Complicating the use of the local income tax is its impact on economic development. When there are areas within a region or metropolitan area where the tax is not levied, there are opportunities for individuals and businesses to vote with their feet, that is, to locate outside the boundaries of the income tax jurisdiction. A remedy is to offer a metropolitan-wide tax sharing agreement. Marginal economies, such as found in many poor, rural and small communities, will be unable to gain much from a local income tax, although there may be more income to tax in one of these communities than retail sales captured by a sales tax.

## Service charges

Bird (1993: 212) asserts that the "first rule of local finance should be: 'Whenever possible, charge.'" Given the twin pressures of the ever-present anti-tax sentiment and the drive to instill more market pricing into public services, more government entities have turned to service charges and user fees as an alternative revenue raising method. Charging for services is the norm for business-type enterprise operations, such as city owned water, sewerage, electricity, or gas distribution services. An issue for these enterprise operations is whether the general treasury will reap any subsidies from cash-rich utility services, and, if so, how much and under what justification (for example, recovery of overhead, citizen dividends, in-lieu-of property tax payments, etc.).

A market economy charges prices, providing signals to producers on what to provide and rationing goods and services among competing consumers. Governments can use prices for goods and services in a similar manner. Service charges can help avoid substantial waste by making users temper their consumption. Some programs offered by the government benefit the individual with little spillover effects on others, thus making it easier to assign a price. However, there are other public services that benefit the individual as well as the general society, such as public health immunization programs to avoid an epidemic. Assigning a price, without any provision for discounts or waiver, may harm society by discouraging widespread use that otherwise might prevent the spread of an infectious disease. Setting a price at an amount to recover the cost of the particular service allows the use of variable pricing, such as peak-pricing differentials (one price during peak-periods and another one at off-peak periods), but limits the ability of program managers to charge the fee-payer more than the cost of the service. More troubling from an equity standpoint is that service charges place a disproportionate burden on lower-income people, especially if the normal consumption pattern varies little by income.

A recent development that will encourage state and local governments to focus more on service charges is the new generally accepted accounting standards (GAAP) that require the reporting of cost of service by function



(Governmental Accounting Standards Board 1999). The new “statement of activities” (that replaces the “income statement”) reveals for the first time the difference between program revenues and cost, with the (typically) reported deficit covered by general revenues. As public officials become more familiar with this new accrual accounting application, the probability increases that annual budget discussions will devote more time to setting charges for services at or near the cost of service, where feasible.

## Debt financing

Debt and taxes go together because both are sources of funding for public services and projects. There is a fundamental difference, however. Once a tax is levied by the governing body, taxpayers are obligated to pay if they engage in the taxed activity. Just because a governmental jurisdiction wants to borrow money does not mean that it will enjoy market access at an acceptable cost of capital. Therefore, acquiring money through the public capital markets depends upon the nature of the securities offered, the investors that are likely to purchase the securities, and the ability of the debt issuer to bring an offering to the market (and, of course, to pay the resulting debt service on time and in full).

Instead of focusing exclusively on American local governments, this section reviews the basic similarities and differences in the capital market experiences of subnational governments in America and Canada (Hildreth 2005, 2006; Hildreth and Zorn 2005). These governments have long enjoyed the power to enter the private capital markets to finance capital assets and, in some cases, operating deficits. In return, investors have experienced few economic defaults on these direct obligations. The structure of subnational borrowing may help explain this success yet suggest the nature of the market-based stress that local governments face in debt financing.

American state and local governments issue debt securities – generically labeled *municipal* securities – in a domestic capital market comprised of investors seeking to benefit from an exemption from federal (and usually the state) income taxes on the interest earned from loaning the money to the governmental entity. The American tax-exempt capital market permits state and local governments to borrow money at a lower cost than the national government that issues sovereign securities in the taxable capital market. Unlike in America, there is no domestic tax-exempt capital market in Canada. In fact, the debt issuance experiences of Canadian provincial and municipal governments are exclusively taxable and often conducted in foreign capital markets. American state and local governments look at any alternatives to the tax-exempt domestic market – namely, the taxable market, whether domestic or foreign – with great trepidation. Many state and local governments in America have some experience with the taxable

domestic market by issuing private activity bonds that benefit private business, but only a few large and well-known issuers (such as New York City) have experimented with foreign debt issuance.

### Nature of the securities

US tax laws specify that the interest on the obligations of a state, a territory, or a possession of the US, or any political jurisdiction of any of the foregoing, or of the District of Columbia, is not subject to income taxes as part of gross income. This definition permits an ever increasing number of sub-state political jurisdictions (including limited purpose special districts) to enjoy the benefit of issuing tax-exempt debt. Congress, repeatedly, has narrowed the allowable purposes in order to save the revenue loss. State income taxes typically exclude in-state interest only. Although no other country has repeated this market design, the province of Ontario issued one series of 5-year bonds in 2003 that enjoyed only a provincial tax-exemption. However, political changes undermined the program before it could get established as a viable debt instrument for both the issuer and the investing public.

American state and local governments must issue “taxable” securities when the purpose provides substantial private business benefits, as defined from time to time by the US Congress. Moreover, the interest paid to investors by US sovereign bonds and private business securities is taxable under income tax laws. In contrast, Canadian provincial, municipal, sovereign, and private business securities are issued in the taxable market.

State and local governments, on average, borrow at a rate about 40 basis points (with each basis point equal to one hundredth of a percent) *below* the sovereign bonds – due to the tax-exempt nature of the market. In contrast, Canadian subnational debt has a quality spread that averages about 55 basis points *higher* than Canada’s sovereign bonds.

State and local government securities are exempt from direct federal securities regulation, unlike corporate and foreign (including Canadian sovereign and subnational) borrowers in America. However, the US Securities and Exchange Commission has indirectly regulated municipal securities. Indirect regulation occurs by placing the burden on the original buyers of state and local government debt – the wholesalers known as broker-dealers or underwriters – to enter into business only with debt issuers that agree to make certain specific primary and secondary market disclosures. Unlike the centralized US securities system, publicly traded corporate securities are regulated at the provincial level in Canada, although more coordination is emerging. These provincial systems exempt governmental securities.

Only one-fifth of all subnational debt in America is issued in the form of “general obligation” bonds that carry a legal pledge of the jurisdiction’s full

faith and credit taxing power. More frequently, bonds are secured by a legal pledge of a dedicated local revenue stream – thereby earning the “revenue” bond label. Examples of pledged revenues include net receipts of public enterprise operations; expected receipts from dedicated local taxes (such as tourism-related taxes); agreements to pay lease obligations sufficient to retire the debt on a building, facility or major piece of equipment (with or without a mortgage on the property); or, obligations secured by some other type of contractual agreement. When the security behind the bonds represent an essential service, such as a water or sewer system, the revenue bonds gain added value, especially when the general obligation credit is judged to have more political risk (unwillingness to pay). In contrast, revenue bonds require more investor scrutiny since the collateral is tied to specific, but estimated, revenue flows and there is no legal recourse to the general taxpayers. Many of these obligations are designed to circumvent the more onerous rules that limit the use of the general obligation pledge. Investors may accept this non-debt legal interpretation, but, nevertheless, expect the issuer to meet its financial obligation.

In Canada, most debt is direct and unconditional. Traditionally, even provincial enterprises, such as the capital-intensive hydroelectric operations, pledged the general credit of the controlling province. Recent efforts to deregulate provincial enterprises, such as Ontario Hydro, evidence a move to borrowing that is backed solely by the enterprise’s own credit quality.

American state and local governments issue bonds for capital assets and infrastructure with the maturity tied to the life of the asset. Although 30-year maturities are common, most credit standards encourage a shorter average maturity. Canadian provincial and municipal governments traditionally use intermediate maturities, with eight to ten years frequent. Canadian provincial governments have a history of borrowing for consolidated deficits, so this intermediate length makes sense. Canadian municipalities must explicitly tie debt maturity to asset life.

Debentures issued as sinking fund securities are common in Canada, meaning that maturity is at the end of the term, with only semi-annual interest payments during the interim. In contrast, American state and local governments typically issue serial bonds, with principal and interest due each year.

Generally, state and provincial rules prohibit local governments from borrowing to cover year-end operating deficits. Instead, borrowing is for the acquisition of capital assets. Canadian provincial governments have borrowed to finance consolidated deficits, fostered by an accounting system that consolidates operating deficits with capital acquisition. In recent years, some state governments have resorted to deficit borrowing, including Louisiana (in 1988), Connecticut (in 1991 and 2002), California (in 2002 and 2003), and New York City (in 2002). In such cases, the securities were widely understood as deficit financing bonds, with intermediate terms.

## Investors

In the US, about 65 percent of state and local government securities are held either by households or in retail-traded financial instruments. In contrast, Canadian provincial bonds are held primarily by foreign investors (29 percent in 2004) and personal pension plans (21 percent), consistent with a taxable investment that has yields higher than the sovereign government but with low credit risk. Canadian municipal bonds are primarily held by individuals (37 percent) and by provincial and municipal accounts (combined for 20 percent). A municipality holding its own bonds raises arms-length transaction concerns. Provincial holding of municipal debt reflects another tradition of placement instead of public debt sales.

Pension plans in America have no economic incentive to invest in lower-yielding tax-exempt securities, and Congressional proposals to change that by giving the Social Security system a federal interest rate subsidy has failed repetitively. In contrast, the Canadian Pension Plan (CPP) traditionally invested in non-marketable 20-year securities of participating provinces (all but Quebec that has its one pension system), at a lower than market price. Each participating province received a yearly allocation tied to that province's worker contributions, with the province able to reallocate that amount among its various agencies. For example, in 1992, the CPP held 31 percent of Ontario's provincial purpose debt and 35 percent of Ontario Hydro's debt. For years, Alberta municipalities received the benefits of the lower CPP-related borrowing rates because that province allowed local governments to pool their borrowing needs through a provincial financing authority; however, the province later reclaimed the full allocation to meet its own needs. Nationally, in response to anemic investment results, the Canadian Parliament enacted in 1997 a pension investment board charged with active management of the CPP portfolio to achieve market results. Targeted investments in provincial bonds were limited, only allowing each province to roll over its bonds for one further 20-year term. Still, the Canada Pension Plan offers a pool of patient capital that is not available, in parallel fashion, to subnational borrowers in the United States.

A government should not make a market for its own debt. Although infrequent in America (except for cash-flow notes in some cases), significant market-making activities have occurred in Canada in the recent past. Because most American municipal securities are tax-exempt, with lower yields, there is no incentive to hold them in the asset accounts of an entity that does not pay taxes. However, Canadian provinces have used their captive pension funds and other controlled assets as a buyer of their subnational securities. For example, until 1990, the investment rules of Ontario's public pension funds favored the purchase of provincial bonds through private placement. Due to anemic returns, however, the pension

systems must now purchase provincial and municipal securities on the open market based on competitive returns.

In Canada, the financial intermediary that fosters home ownership – the Canada Mortgage and Housing Corporation (CMHA) – serves as a large purchaser of provincial securities whereas similar government-sponsored corporations in America – such as FannieMae – have no incentive to invest in tax-exempt securities. As Canada’s national housing agency, CMHC borrows money from the capital markets and the Government of Canada to lend to private borrowers. One program provides insurance against borrower default on certain mortgages. Premiums are invested in various securities, with provincial bonds comprising 15 percent of their holdings in 2004, second only to those backed by the Government of Canada and guaranteed.

Very few American state and local governments have ventured into foreign capital markets to issue taxable debt. Provincial (and some municipal) borrowers in Canada have made extensive use of foreign capital markets, including, but not limited to, the US taxable market (termed “Yankee” bonds), but they have dramatically reduced their foreign offerings in recent years. Canadian subnational governments were hurt by foreign currency exposure prior to the development of currency swaps.

### **Debt issuance process**

Canadian finance executives tend to enjoy more discretion within their own governments to engage in debt acquisition and liability management than their American counterparts, likely due to the parliamentary form of government. In contrast, American states exhibit more pronounced legislative inquiry into alternatives, increased opportunities for vocal public disagreements and political repercussions, and even direct voter approval.

Although most state constitutions in America impose a legal limit on the amount of property-tax supported debt, revenue bonds are not similarly limited. North Carolina is the only state that schedules and conducts the sale of general obligation bonds on behalf of its local governments. More commonly, a state may have a nominal state notice requirement but more stringent local approval requirements, such as voter approval for long-term debt that obligates future taxpayers. Local policies, independent credit ratings, and the cost of capital serve to ration the debt creation appetite of most local officials. Moreover, rating changes can influence reelection probabilities. In contrast, Canadian municipalities face more provincial control, with pre-approval required. For example, Alberta has required provincial approval for local debt with maturity beyond three years. Recent trends suggest Canada is following the American practice of delegated local control within bulk borrowing limits and credit-rating defined debt capacity ranges.

Buying bonds from the issuer and selling them to the ultimate investor is the role of the market intermediary. In Canada, the term is “fiscal agent,” whereas the term used in America is “underwriter” of the security offering. When American state and local governments sell their obligations by auction, they select the underwriter offering the lowest cost of capital. To do so, however, requires that the debt issuer assume the burden of debt structuring and market timing, a skill beyond the expertise of many internal staff. This condition has led to the use of independent financial advisors to help guide the decision-making. With 65 percent of state and local debt volume sold by negotiation, picking the underwriter(s) is open to selection on a basis other than economic pricing, and with duties that extend into structure and timing matters. Most academic research conducted on the US tax-exempt market finds competitive sales more efficiently priced than negotiated sales. Canadian municipal and provincial bonds are sold by negotiated sale. For example, market-savvy provinces are known to make their own market-timing decisions, call one of the pre-selected co-managers of a large syndicate, and announce it wants to sell bonds into the market at an appointed time in a matter of hours. These actions illustrate the range of decisions involving capital markets that can flow from fiscal decentralization.

### **Which federalism?**

From a local government perspective, the big question – “Which Federalism?” – is best answered by the governmental structure that allows locally elected officials to tailor fiscal decisions to local needs. This local power should include the ability to design, levy, collect, and use locally incurred taxes. A counterpart to the power to tax is the power to incur debt. Debt imposes a future obligation on taxpayers or ratepayers to generate sufficient revenues to cover the debt service. In essence, debt securitizes future revenue flows. Thus, the political and economic choices embodied in local tax structures influences both tax policy and debt policy.

Tax structures are not static; they are revised frequently to adapt to changing circumstances. Moreover, when analysts rank tax systems they must be cognizant of the many ways tax structures can influence the results. A review of the contemporary aspects of property and sales tax structures illustrate the forces that can strain the effectiveness of each tax. Accordingly, this chapter introduces separate tax structure indexes for the property and sales tax. This design reflects the base, rate, and yield features embodied in tax systems. One benefit is that it offers a way to observe the degree of policy convergence and tax design variation.

Interesting findings emerge from a comparison of the two indexes. The high side of the property tax structure index could be considered negative

and indicative of the pressures to reform the tax. In contrast, the high side of the sales tax structure index could represent the preferred sales tax policy habitat. This last observation derives from the repeated efforts (but often failure) in most states with a sales tax to expand the sales tax base in response to the general shift in the economy from goods to services (Tannenwald 2002; Duncombe 1992). At the high end of the sales tax structure index are the states that tax a broad range of services. Different index elements may affect the results.

The current chapter offers a single period perspective, instead of a multi-period test of tax policy variation and convergence.<sup>3</sup> Still, these results suggest less variation in the index measure for the sales tax than the property tax. In contrast, Annala (2003) finds just the opposite over a 20-year period. One explanation for these different results is Annala's approach of measuring each tax as a ratio to gross state product instead of using a measure that captures the multi-faceted tax structure as suggested by Alt (1983).

As an exploratory effort, the two indexes (one for the property tax and the other for the sales tax) are not intended to be definitive. Instead, the constructed indexes lay the groundwork for future research. Index components can be refined and calibrated, with the sensitivity of results discussed. Changes over time could yield clues to policy shifts. Case studies could clarify decisions behind the data. Differences between cities and counties suggest the value of different measures on the strain placed on their particular tax structures (Pagano and Johnston 2000). In addition, explicit measures of tax incidence could be incorporated. A desirable outcome from refining each tax structure index is to advance the discussion of an overall metric for viewing the simultaneous effect of political and economic choices, as suggested by Alt (1983).

In summary, fiscal decentralization should translate into options for generating own-source revenues and issuing debt to finance local preferences. The goal is for accountability to rest with voters and markets, not with hierarchy.

## Notes

- \* I appreciate the comments on my tax policy indexes by Ed Flentje, John Wong and Glenn Fisher, and the spreadsheet assistance of Felany Opiso and Anthony Swartzendruber, both George Van Riper Endowed Fellows in Public Finance. I remain responsible for what I have written.
- 1 Determining the details of local government finance in America is not as easy as it is for state government finance because a census of government finance is not taken yearly. Traditionally, the National Income and Product Accounts (NIPA) only reported a combined state and local government sector. Starting in 2005, however, the US Department of Commerce (specifically, the Bureau of Economic Analysis) plans to publish details on the yearly estimates of local government data (Baker 2003, 2005).

- 2 Even the need for administrative simplification and cost efficiencies due to Hurricane Katrina made it difficult to overcome the political support in the State Legislature for protecting the seven elected officials (New Orleans Times-Picayune 2006). A change requires a state constitutional amendment which is before state voters in November 2006.
- 3 Using comparable data for the 1991 period for a sales tax stress index finds similar results as the 1997 period, with little change among states in the high and low ends of the ranks.



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# 7

## Fiscal Federalism and Intergovernmental Revenues in the US

*Christopher W. Hoene*

The American federal system has persevered for more than 200 years.<sup>1</sup> In the annals of time, 200 years is not very long and we might better describe the American federal system as the American federal experiment. However, in modern history, and particularly the history of the nation-state, the longevity and stability of the American federal system stands out as remarkable, both for the strength of the institutions it created and the ability of the system to adapt to changing times, circumstances, and demands.

In the 20<sup>th</sup> century, the American federal system underwent fundamental changes in response to economic and political circumstances. Today, the intergovernmental relationships that comprise and surround the system are dramatically different than they were 100 years ago. A resident of the United States in 1907 lived in a federal and intergovernmental system that provided few services in comparison to a resident of the United States in 2007. The 1907 resident would pay most taxes to local and state governments and rely primarily on these levels of governments for key services and infrastructure.<sup>2</sup> The federal government's role in 1907 was limited, both in terms of its ability to generate revenue (the federal income tax having not yet been enacted) and in spending where it confined itself largely to national defense. In contrast, the 2007 resident lives in a system where the roles of all levels of government have expanded dramatically, with the locus of activity shifting over time between federal, state, and local governments, and in which at any given moment, in any given service arena, the roles of these three levels of government are fundamentally intertwined and often difficult to delineate. While the federal government is still primarily responsible for providing for the common defense, all levels of government are now involved in the other three principle purposes defined by the US's founding fathers – establishing justice, insuring domestic tranquility, and promoting the general welfare of the American people.

Growth of the role of government in the American federal system has coincided with the growth of the United States as an economic power and

the growth of economic wealth of its residents. Over the past 50 to 60 years the United States – through its federal, state, and local governments – has established institutions to protect and enhance the economy, created a vibrant and strong middle class, laid the infrastructure for future economic and demographic growth, and made substantial efforts to aid those residents left behind. Today, considerable debate exists as to the success or failure of these efforts, and the capacity of government to play such a large role in the economic and social future of the nation. Cast in this light, the American federal system is an experiment that is a mere half-century old.

Much of the debate over the future of federalism in the US revolves around fiscal federalism – the roles of federal, state, and local governments in extracting revenues and providing services. Which level of government has responsibility and authority and how should the revenue be generated and shared, or not shared, to meet the needs of the American people? The expanded role of government over the past century has obviously come with increased government revenue capacity and spending, and with increased flows of revenues between levels of government. The size and direction of these flows have been in constant flux and are the source of much of the tension between levels of government. This chapter examines the state of fiscal federalism in the US, focusing on the intergovernmental flows of revenues and spending between federal, state, and local governments. Much of the analysis will focus on changes occurring over the past two to three decades as the balance in the American federal system has undergone a key directional shift.

## **Evolution and devolution of the American federal system**

The defining characteristic of the American federal system, as it has evolved and devolved, is that the system is inherently messy. Lines of authority and flows of revenue are rarely clearly demarcated and have become more complex and intertwined over time. Over the last century in particular, it became nearly impossible for the casual observer to decipher what level of government holds the responsibility for delivering a particular service. Martin Grodzins (1960: 265) provided an oft-cited example of the messiness of the system:

The Sanitarian is appointed by the state under merit standards established by the federal government. His base salary comes jointly from state and federal funds, the county provides him with an office and office amenities and pays a portion of his expenses, and the largest city in the county also contributes to his salary and office by virtue of his appointment as a city plumbing inspector. It is impossible from moment to moment to tell under which governmental hat the sanitarian operates...He is a federal officer when impounding impure drugs shipped

from a neighboring state; a federal-state officer when distributing typhoid immunization serum; a state officer when enforcing standards of industrial hygiene; a state-local officer when inspecting the city's water supply; and (to complete the circle) a local officer when insisting that the city butchers adopt more-hygienic methods of handling their garbage.

Similar examples in other areas of government activity abound.

The inherent messiness of the system is apparent in reviewing the intentions of the founding fathers and their perceptions of federal systems, in theories about trends and changes in the American federal system over time, and in the flows of authority and revenues between levels of government in the system in its current iteration.

## **Federalism and the American federal system**

Federalism, as it is commonly understood, refers to a system of government where authority and responsibility are constitutionally separated between a central or national government and sub-central or subnational governments (O'Toole 1993). Such a definition seems to be universally agreed upon among federalist scholars and advocates.

Debate diverges, however, when examining the American version of federalism, the intention of the framers of the US system and its constitution, and the structure of modern federalism in the US. Diamond (1974) makes a persuasive case that federalism, in its purest form, refers to a loose association of states in which the states retain all sovereign power and agree to confederate for specific purposes, such as a common defense. It seems clear that the system envisioned by the founding fathers, exhibited in the writings of James Madison in *Federalist No. 39* and in Diamond's analysis of the framers' intent, was designed to be more centralized, or national, than this pure definition of federalism.<sup>3</sup> Concerned that a national form of government would impose upon state sovereignty, but also concerned about too loose a confederation resulting in limited national strength, the framers sought to strike a balance between the two forms of government. Madison was pretty clear that the proposed US Constitution was neither wholly federal nor wholly national. Similarly, Derthick (2001) describes the resulting compromise as a compound republic.

## **The development of the American federal system**

Studies of American intergovernmental relations are riddled with labels of federalism – different descriptions of the types of federalism, or elements of federalism, depending upon the topic or time period in question. Examples, many of which are utilized and mentioned here, include dual

federalism, creative federalism, cooperative federalism, coercive federalism, competitive federalism, fend-for-yourself-federalism, fiscal federalism, and regulatory federalism. The full list is surely longer, but the point is that there is an abundance of analysis of the American federal system and its changes over time.

Federalist scholars generally point to three common periods in the development of the American Federal System over time – a long period of dual federalism, followed by a period marked by expansion, cooperation, and creativity, then followed by an era of devolution, competition, and increasing antagonism. These theories correspond with changes in public attitudes and presidential leadership. Correspondingly, flows of intergovernmental revenues, and the mechanisms through which these flows occur, have changed as the locus of control and authority has shifted between levels of government.

### **Dual federalism**

Dual federalism refers both to a theory of federalism and a period of time. As a theory, it is generally used to describe the American federal system – one involving two main levels of government, in this case the federal government and state governments, that exist without relying on the other for authority or assistance (O'Toole 1993). Federal and state powers are viewed as separate and distinct, with minimal overlap (Rivlin 1992a). The American system is often described as one of dual federalism because it constitutionally apportions and protects the states and the federal government. Dual federalism is also often used to describe a period of time in American history. The predominant view is that dual federalism was the model of intergovernmental relations in the United States from its birth up until the 1930s (Rivlin 1992a; O'Toole 1993; Conlan 1998). The system during this time was characterized by broad state sovereignty, little federal power except in areas of defense and international diplomacy, and government spending and activity dominated by state and local governments. Flows of revenue between levels of government were minimal.

### **A “New Deal,” the “Great Society,” and creative federalism**

The period following the 1930s, during which the roles and size of government increased substantially, is often characterized as more cooperative, referring to the evolution of the system into one in which the roles of federal, state, and local governments became more intertwined and less clearly separated. While cooperative elements might be found in any period in American intergovernmental history, the predominating view is that cooperation and a growing intergovernmental partnership better describe the evolution of government roles from the 1930s through the 1970s. During this period, a much larger and stronger role for the federal government emerged in response to the Great Depression, WWII, and the

rise of the US as a world economic power. A larger federal role translated into dramatic increases in federal programs, spending, and, in intergovernmental terms, to substantial increases in the number and size of grants to states and local governments for the purpose of carrying out and implementing federal policy goals and programs.

Changes in the American federal system from the 1930s to 1970s were spurred on by two developments in particular: President Franklin D. Roosevelt's "New Deal" and President Lyndon B. Johnson's "Great Society." President Roosevelt's response to the economic hardships of the Great Depression was to create a set of federal institutions and programs that would revive and invigorate the US economy, and to provide a safety net to the many Americans out of work through jobs building America's infrastructure and national social insurance programs. During President Roosevelt's tenure, the federal government embarked upon social security and unemployment insurance programs and significantly expanded federal power in water/flood control infrastructure and banking and credit institutions to protect wealth and the economy. Grants to state governments were the primary intergovernmental mechanism used to facilitate many of these programs.

In the 1960s, President Johnson's administration expanded the federal government's role in response to dissatisfaction with state governments' abilities to cope with social and economic disparities among states and localities – a development that some scholars have described as creative federalism, noting the activist federal role in social reform (O'Toole 1993). During this time, the federal government assumed a much larger role in arenas traditionally thought of as state venues – poverty reduction, public education, job training, health, waste and sanitary services, housing, and civil rights. Federal grants to state governments were again a primary mechanism used to implement federal policies and programs, but an increasing number of federal grants bypassed the states altogether, going directly to localities and individuals, particularly in urban areas.

### **New federalism and a "sorting out"**

The cooperation that may have characterized American federalism from the New Deal to the Great Society continued into the 1970s under the tenure of President Richard Nixon. A significant change was also underway as the Nixon administration sought to shift the locus of authority and control for designing and implementing programs back to state and local governments under his New Federalism proposals. The language used to describe these proposals and their intention was a sorting out of government roles and responsibilities (Nathan *et al.* 2003).

In the 1970s, problems with the rapid growth and largesse of the federal government became evident in signs of waste, inefficiency, and lack of accountability. The number and size of federal grant programs – more than

500 in total – often overlapping across a multitude of programs designed to address separate but related issues, increasingly was seen as a problem. Perceptions of the need for federal predominance also began to wane (Rivlin 1992a; Conlan 1998). Subsequently, President Nixon's administration sought to engender greater administrative efficiency by consolidating existing grant programs into several larger programs under which greater authority and control would be devolved to state and local governments. The Nixon administration, in essence, sought to continue the federal government's commitment to the programs started under previous administrations, but chose different mechanisms for implementing programs and incentivizing behavior. These mechanisms were intended to grant state and local governments greater flexibility to design programs to fit local needs, while maintain the funding source at the federal level and increasing accountability through the consolidation of programs.

Two key mechanisms that the Nixon administration introduced in this regard were block grants and the federal General Revenue Sharing (GRS) program (Rivlin 1992a; Conlan 1998; Nathan *et al.* 2003). Up until this point, federal grants to states, localities, and individuals had occurred through categorical grants – grants in specific programs areas that came with detailed rules about distributing the grant funding, were overseen by federal bureaucracies and often created state and local bureaucracies, and were protected thereafter by special interest groups seeking to sustain and increase the grants. Block grants, in contrast, sought to consolidate categorical grant programs into larger grant programs and then devolve more authority and flexibility to state and local governments. President Nixon's approach was to take advantage of the federal ability to collect revenue and the state and local ability to structure policy to their communities (Conlan 1998).

The federal GRS program was the logical extension of President Nixon's block grant strategy (Conlan 1998). The program, enacted in 1972, was designed to transfer a share of federal revenues to state and local governments with minimal rules attached, allowing state and local governments to use the funds for general-purpose service needs. The funds were provided in addition to federal grants funds in other categorical and block grant areas, and were provided directly to state governments, and earmarked, or passed through, to local governments, guaranteeing that states could not siphon off the local share (Rivlin 1992a). Part of the intent behind the program was to encourage and provide funding for state and local capital investment (Kincaid 1999).

Politically, the GRS program was never well supported at the federal level. President Nixon's backing, combined with a strong intergovernmental lobby on the part of state governors, big city mayors, and other local officials managed to push it through the Congress in 1972. But, funding for GRS never really increased dramatically, as the Nixon administration and

state and local government officials had intended (Wallin 1998). Similarly, President Nixon's goal of widespread consolidation of categorical grants also failed to materialize. The result was that the categorical grant programs of the previous administrations continued to expand during the 1970s (Rivlin 1992a, Conlan 1998).

### **Paradigm shift: de facto devolution and regulatory federalism**

The changes that were proposed, and implemented to some degree, under the Nixon administration eventually gave rise to a paradigm shift in American federalism beginning in the late 1970s and reaching fruition when President Ronald Reagan was elected to office in 1980. This shift is often described in competitive terms, such as combative, antagonistic, and coercive – references to a souring of intergovernmental relationships as federal, state, and local governments competed for control and authority. Viewed as a return to the period of dual federalism, the shift implies that there were heightened rivalries and struggles for control between federal and state governments in particular, but also among federal, state, and local governments (Rivlin 1992a; Conlan 1998; Kincaid 1999). While some scholars argue that competition better describes American federalism throughout history (Scheiber 1966), the description has been most commonly used to describe American federalism and intergovernmental relations since 1980.

Another word commonly associated with this period, from a federalism perspective, is devolution (Conlan 1998). Devolution, in its simplest form, refers to the delegation of functions and authority to lower levels of government. Advocates for devolution typically point to the need for more efficient and effective government, achieved through more responsive state and local governments (Kincaid 1999). The Reagan administration used phrasing around the word devolution as a way of portraying proposals and policies to reduce federal commitments to certain programs, arguing that more control needed to be placed in the hands of state governments in particular.

Under President Reagan, the block granting of social programs proposed and started in the previous decade were continued. This time, however, federal funding support for the block granted programs was reduced, as was federal support for a multitude of federal government social programs. Through these cutbacks, the Reagan administration systematically scaled back the federal commitment to state and local governments. The GRS Program was gradually eliminated, first through elimination of the state portion in 1980 (this occurred under the Carter administration, with transfers to state governments closing out in 1982) and then non-renewal of the program, effectively ending it in 1986. In essence, the federal-state-local partnership that had developed over the previous four decades began to be dismantled as the Reagan administration sought to reduce the federal



government's commitment to social programs and other levels of government (Conlan 1998).

Not surprisingly, President Reagan's version of devolution had a negative fiscal impact on state and local governments. State and local officials should, in theory, advocate for devolution on the grounds that it provides them greater flexibility and authority. The Reagan administration's version of devolution, while transferring some authority, typically also undercut the revenue capacity needed to maintain the programs. Kincaid (1999) described the result as *de facto* federalism, a process that combined reductions and elimination of federal programs with shifts in responsibility to state and local tax bases. State and local governments may have ended up with more authority, but they also ended up lacking the revenue capacity to maintain service levels. Kincaid commented that the term devolution was most often used for political purposes, to put a positive spin on budget cuts and transfers of responsibility.

The *de facto* devolution of this period also coincides with the rise of regulatory federalism. Regulatory federalism refers, in this case, to increasing federal actions to regulate the activities and behavior of state and local governments. The 1980s and 1990s would see the rise of these activities in the form of increasing numbers of mandates and preemptions. Mandates refer to federal laws and statutes that require state and local activity in a given arena, while preemptions refer to federal appropriation of state and local authority (or state appropriation of local authority). Kincaid (1999) calls these mechanisms coercive tools and notes that they are particularly attractive to federal officials because they allow them to take credit for policies enacted, while passing the costs and responsibility on to lower levels of government. Similarly, Nivola (2002) notes the tendency of both tools to increasingly regulate local governments, while providing them less funding. State and local officials' opposition to unfunded and underfunded mandates eventually resulted in the passage of the Unfunded Mandates Reform Act (UMRA) in 1995, requiring a point of order that all federal laws and statutes enacted with an unfunded mandate be designated as such in the enacting language. Unfortunately, UMRA has a variety of loopholes and the point of order can be overridden by a majority vote in Congress.

A combination of *de facto* devolution and regulatory federalism has continued to dominate American federalism since the 1980s, in varying degrees. President George Herbert Bush sought less dramatic changes in intergovernmental flows than the Reagan administration and President Clinton returned to greater commitment to social programs. But, the idea of ceding control to state governments continued to prevail, most notably occurring through the shifting of the federal welfare program (Aid to Families with Dependent Children – AFDC) to a block grant program operated by state governments under the Temporary Assistance for Needy Families (TANF) program in 1996.

**Table 7.1** Periods in the development of American federalism

Period	Years	Federal government roles and programs	Intergovernmental mechanisms
Dual Federalism	Pre-1930s	<ul style="list-style-type: none"><li>– National defense</li><li>– Infrastructure</li></ul>	Separate and distinct roles
New Deal	1930s–1940s	<ul style="list-style-type: none"><li>– Social security</li><li>– Unemployment insurance</li><li>– Power infrastructure</li><li>– Water/flood control</li><li>– Banking and credit</li></ul>	Grants to state governments and some grants to localities and individuals
The Great Society and Creative Federalism	1960s–1970s	<ul style="list-style-type: none"><li>– Education</li><li>– Job training</li><li>– Health</li><li>– Housing</li><li>– Civil rights</li></ul>	Continued increase of grants to states and increased use of direct grants to localities and individuals
New Federalism	1970s–	<ul style="list-style-type: none"><li>– Expansion of existing programs</li><li>– General Revenue Sharing</li><li>– Block grant programs in workforce and community development</li></ul>	Consolidation of existing grant programs; block grants to states; general revenue sharing
Devolution and Regulatory Federalism	1980–	<ul style="list-style-type: none"><li>– Reductions in social program funding</li><li>– Expiration of General Revenue Sharing</li><li>– New block grant programs, including welfare aid</li></ul>	More block grants to states, combined with cuts in funding for social programs and block granted programs; General Revenue Sharing allowed to expire
Current Proposals	2002–	<ul style="list-style-type: none"><li>– Proposed block grants for housing, pre-school education, and health services for low-income population</li></ul>	More block grants and cuts in social programs; one-time fiscal relief for states

The presentation of models and stages of federalism in the US, summarized here in Table 7.1, presupposes that some fairly straightforward distinctions can be made between the stages. But, even this is up for debate. Elazar (1962) and Grodzins (1960) both argue that the model of cooperation is more prevalent during the period usually characterized as one dominated by the model of dual federalism. Scheiber (1966) counters that competitive elements have better described the American federal system throughout its history. All make persuasive arguments, and they are probably all correct in part, depending upon what part of the system is under scrutiny and at what period in history. President Nixon's New Federalism is a good example of the ambiguity between the models and stages. Are his New Federalism proposals – that in methodology more closely resemble those of the period that followed him, but in practice maintained and increased federal roles of the administrations that preceded him – indicative of cooperation or competition? The answer may be both, and the conclusion one is left with is that there is substantial overlap and ambiguity in the system.

### **People over places**

Over the last three to four decades, another key structural change in the intergovernmental system has been the shift from funding places to funding people. At the federal level, this means that there has been a shift away from federal grants to state and local governments to grants for payments for individuals. Federal grants for payments for individuals are provided particularly in social insurance and welfare programs, as a means of providing funds directly to needy populations. State and local governments often still administer these grants, but the revenues are otherwise passed through directly to the individuals. Over time, these programs have grown in scale. In contrast, grants to state and local governments allowing them to design and implement programs, or for capital investment, have come to be less emphasized.

Scholars point to a number of factors as the driving forces behind this shift (Rivlin 1992a; Kincaid 1999). One factor was the expansion of the federal government into constitutional rights protection in the 1950s, resulting in emphasis being placed on individuals' constitutional rights, and less on the protected rights of places. The creative federalism of the Johnson administration also sought to find ways to send funds directly to community groups and non-profit organizations as a means of moving down below the level of local government into neighborhoods. Politically, the rise of interest group-driven politics in Washington, DC and state capitals over the past three decades, and the coinciding declining influence of state and local government associations, means that the interest groups representing individuals have more power and ability to protect their programs.

The increasing priority of people over places in federal funding suggests that federal transfers to state and local governments may still increase from year to year, or over a given period of time, but the growth is likely driven by the increasing costs and demands that are driving up payments for individuals – not through new and additional funds for state and local governments.

### **Current proposals: from new federalism to less federalism**

In the new century, under the leadership of President George W. Bush, and with a general public that appears increasingly opposed to tax increases and large government programs, and mired in an economic downturn and slow recovery that began in 2001, the era of *de facto* devolution and regulatory federalism appears likely to continue. The Bush administration's focus appears to be placed more on reducing the size of government by restraining revenues and spending, than on addressing federalism challenges (Nathan *et al.* 2003). Intergovernmental relations are worsening rather than improving in three areas in particular: new block grant proposals, funding for homeland security and disaster preparedness, and fiscal relief for states and localities.

The Bush administration has proposed block granting a number of large social programs. Included among these programs is the federal Medicaid program that provides health insurance for low-income individuals and families – a program administered and partly funded by state governments and for which annual costs have increased rapidly over the past decade. Other programs proposed for block grants are the federal Section 8 housing program that provides federal vouchers for low-income residents to use in securing housing, and the Head Start program that provides pre-school education for children from poor families. In raising the prospect of block granting these programs the Bush administration has also boldly stated that federal funding for these programs would not be increased (in the case of Medicaid, where annual state costs exceed federal reimbursement, resulting in states covering the balance from their general funds), and might be reduced. The states' past experiences with block granted programs eventually being underfunded, and the likelihood of similar results in the recent round of proposals, prompted a tepid response from state governors, and contributed to heightened levels of tension between states and the federal government.

Funding for what is now referred to as homeland security (anti-terrorism efforts, securing borders, and disaster preparedness) is another recently emerging source of tension. In the wake of the September 11, 2001 terrorist attacks on New York City and Washington, DC, state and local governments have assumed increasing responsibilities for terrorism prevention and preparation and, in particular, increased spending on local security in response to federal security alerts. Viewed as a federal responsibility, as part

of the federal role in ensuring national defense, state and local officials have voiced continued concern over the lack of federal support for their increased activities in the areas of anti-terrorism efforts and border security. Similarly, the dramatic lack of a quick and effective government response to hurricanes in the southern states in 2005, the devastation of Hurricane Katrina on the city of New Orleans in particular, exposed very real implications of an intergovernmental system in disarray.

Consternation over block grant proposals and homeland security funding is occurring against a backdrop of a national economy that has been slow to recover from the recession of 2001. The 2001 downturn hit the states particularly hard. In total, states confronted more than \$100 billion in budget deficits for fiscal years 2002–03 and 2003–04 (National Conference of State Legislatures 2003), circumstances that were described as the worst since WWII. States subsequently reduced transfers to local governments, cutting transfers to municipalities, for example, by \$2.3 billion, or nearly 10 percent in fiscal year 2003–04 alone (Hoene and Pagano 2003). Amid these budget shortfalls, state and local officials have sought fiscal relief from the federal government. The Bush administration and US Congress responded by providing \$20 billion in one-time fiscal relief to state governments, but rejected a proposed \$4 billion in similar relief for municipalities. Federal fiscal relief for state governments was welcomed, but also seen as a federal attempt to backfill state revenue losses resulting from the federal income tax cuts passed in 2002 and 2003 (many state income taxes are pegged to the national income tax structure).

Thus, the early part of the new century finds intergovernmental relations in the US in more of an antagonistic situation than in previous years. Federal, state, and local actions might be better characterized as occurring in a fend-for-yourself environment than one that is simply competitive. Economic conditions and reduced revenues are resulting in each level of government turning inward, seeking to steady their own course first, with less regard for the impacts of their decisions on other levels of government.

Whether reviewing the establishment of the American federal system, its development and changes over time, or the flow of revenues among and between levels of government, the enduring trait of the system is its messiness. By the framers' standards, the American federal system is not even wholly federal, but instead a hybrid form of a federal system incorporating some elements of a more centralized, national form of government. Similarly, models and stages of American federalism are fairly well accepted and commonly utilized to describe the development of the system, but even in this arena there is considerable overlap, ambiguity and debate. From a more tangible perspective, in terms of intergovernmental flows – where money is spent and services are delivered – ambiguity and overlap also predominate. It has become increasingly unclear, as the size and scope of government has increased, what level of government is responsible for providing what services and how those services are funded. In short, the

system is inherently messy. Grodzins (1960: 272) describes the intergovernmental complexity that embodies this messiness as marble cake federalism, in which the roles and responsibilities of the various levels of governments, and the revenues they generate and share, are mixed together in an “inseparable mingling of differently colored ingredients, the colors appearing in vertical and diagonal strands and unexpected whirls.” And, as Grodzins argued, the complexity and messiness of the American federalism system is one of its great strengths. The messiness that makes it difficult to sort out and assess is also the very trait that has allowed it to adapt to changing circumstances and new challenges and, in the end, to persevere. However, the complexity, and subsequent lack of transparency, that results may also contribute to disillusionment and disengagement among an American public unsure of what level of government does what, for who, and where.

## Intergovernmental revenues and transfers

Overall, government spending has increased substantially over the past century. Combined federal, state, and local expenditures have grown from \$1.6 billion in 1902 to \$8.3 trillion in 2001 (see Figure 7.1). The preceding analysis points to the following trends and changes in the flow of intergovernmental revenues and transfers among federal, state, and local governments:

- A dramatic increase in government spending over the past century as the role of government at all levels has expanded;

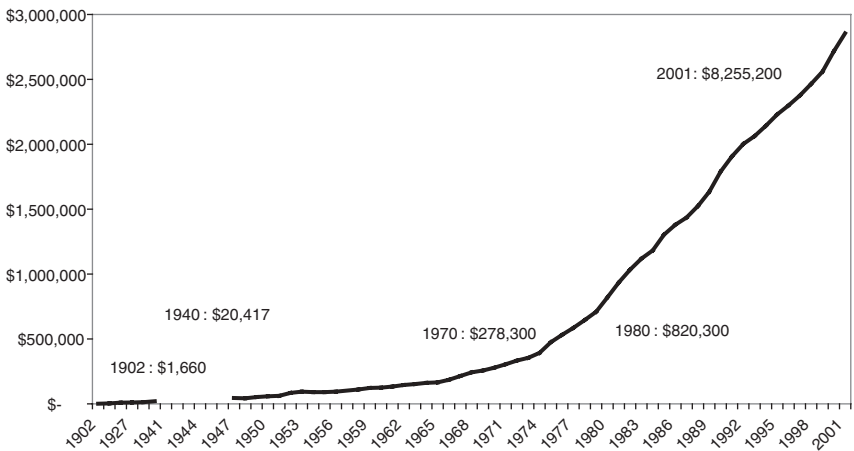


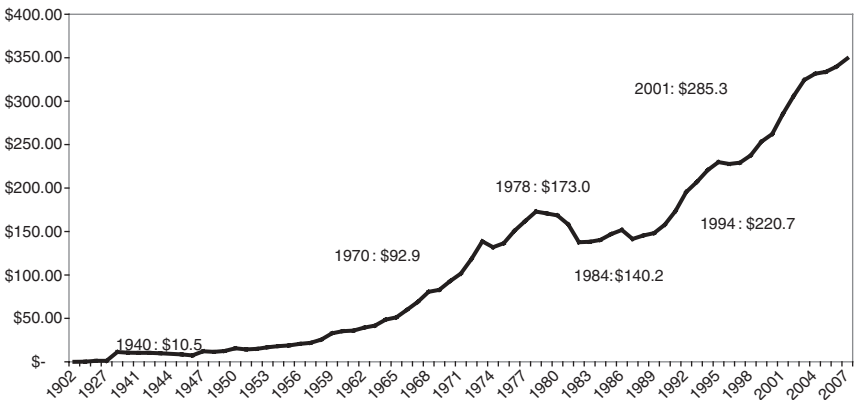
Figure 7.1 Total government expenditures, 1902–2001 (millions)

Sources: Budget of the US Government, 2003 and US Department of Commerce, Bureau of the Census, Historical Statistics on Governmental Finances and Employment, 1982 Census of Governments, Vol. 6, No. 4.

- A steady increase in federal outlays to state and local governments over the past century, slowing or declining after 1980;
- A shift in emphasis away from federal grants for state-local governments and toward payments for individuals;
- Steady growth of intergovernmental revenues at state and local levels up through the late 1970s and early 1980s, followed by a period of decline and recovery;
- A declining federal role, in terms of transfers and aid, at the municipal level, after the late 1970s;
- Increasing prevalence of mandates and preemptions limiting state and local authority.

### Federal transfers

Since, 1902, federal outlays and expenditures have grown dramatically, from \$572 million in 1902 to \$1.8 trillion in 2001. Federal outlays to state-local governments, over the same period, also grew from seven million dollars in 1902 to \$317 billion in 2001. In constant dollars, increases in federal outlays to state and local governments steadily grew, from \$200 million in 1902 to over \$10 billion by 1940 (see Figure 7.2).<sup>4</sup> Following the increases in federal activity enacted as part of the New Deal and Great Society, federal outlays grew to over \$90 billion by 1970, and to \$170 billion by 1980 in constant dollars. Cuts in state and local outlays enacted by the Reagan administration and a Republican party-controlled



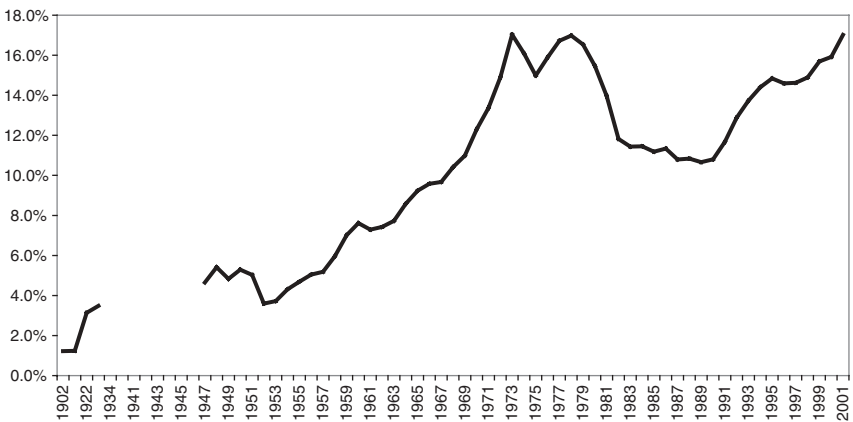
**Figure 7.2** Federal outlays to state and local governments, 1913–2007 (constant 1996 \$, billions)

Sources: Budget of the US Government, 2003 and US Department of Commerce, Bureau of the Census, Historical Statistics on Governmental Finances and Employment, 1982 Census of Governments, Vol. 6, No. 4.

Congress in the early 1980s led to these outlays falling to \$140 billion by 1984. By the early 1990s, however, growth in federal and state outlays resumed, rising to \$285 billion by 2001.

As a percentage of total federal outlays, federal outlays to state and local governments grew from 1.2 percent in 1902 to just over five by the early 1950s, and rising to 12.3 percent in 1970 (see Figure 7.3). With the enactment of the federal GRS program in 1972, and subsequent increases in federal outlays to state and local governments, the total state-local share jumped to 17 percent by 1973 and hovered at around the same rate through much of the 1970s. In the 1980s, as the Reagan cuts were enacted and GRS was eliminated, the state-local share steadily declined, falling to 10.7 percent by 1989. After that time, however, the state-local share of federal outlays began to grow again, climbing to 17 percent by 2001.

As mentioned above, the creation and elimination of the federal GRS program had a substantial impact on federal outlays to state and local governments between 1973 and 1987. The initial allotment of \$6.5 billion was divided by formula between state and local governments, resulting in approximately one-third of the total going to state governments and the other two-thirds passed-through to local governments. However, federal funds under the program were never increased substantially and the revenues provided to state and local governments remained at a similar level through 1980, when the state portion was eliminated (funding stopped in 1982). After that, support for the program continued to wane and became a target for elimination in the early 1980s. The program was allowed to



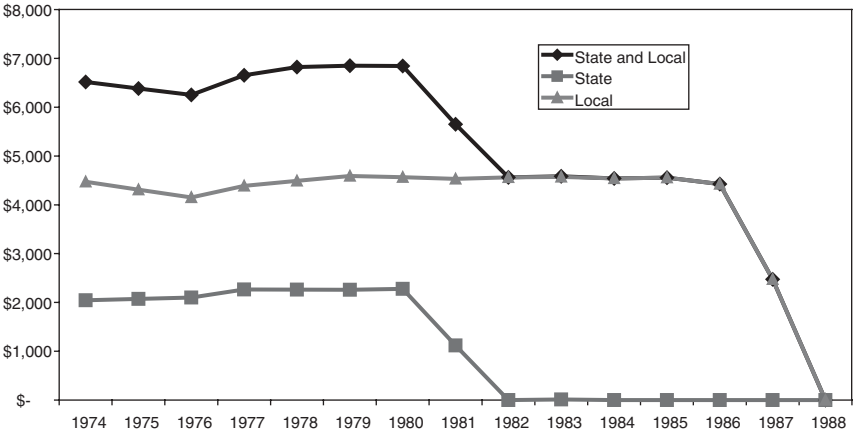
**Figure 7.3** Federal outlays to state and local governments as a % of total federal outlays, 1902–2001

*Sources:* Budget of the US Government, 2003 and US Department of Commerce, Bureau of the Census, Historical Statistics on Governmental Finances and Employment, 1982 Census of Governments, Vol. 6, No. 4.

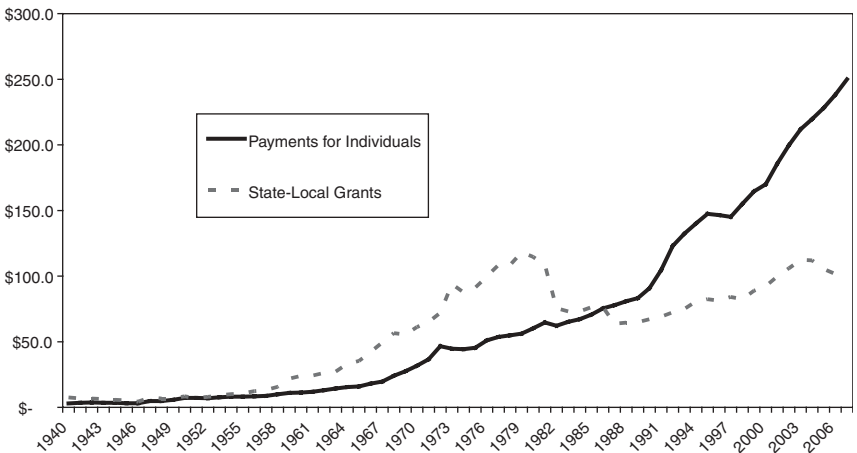


expire in 1986 and GRS funds stopped flowing altogether by 1988 (see Figure 7.4).

Despite the elimination of GRS, federal grants to state and local governments appeared to have recovered and increased steadily throughout the 1990s. In contrast to the growth of the 1960s and 1970s, new federal pro-



**Figure 7.4** Federal general revenue sharing, 1974–88 (millions)  
 Sources: US Department of Commerce, Bureau of the Census, Government Finances (1973–74 through 1987–88).



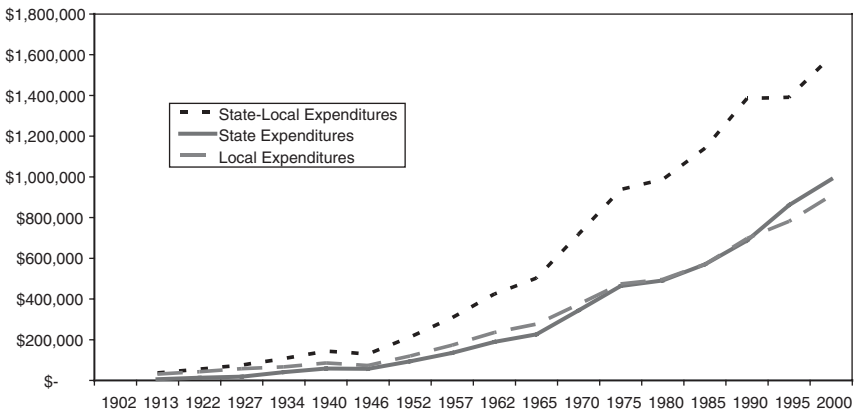
**Figure 7.5** Federal outlays to state-local governments: payments for individuals and state-local grants, 1940–2007 (constant 1996 \$, billions)  
 Sources: Budget of the US Government, 2003 and US Department of Commerce, Bureau of the Census, Historical Statistics on Governmental Finances and Employment, 1982 Census of Governments, Vol. 6, No. 4.

grams did not fuel the growth of the 1990s. Instead, the growth was largely driven by increases in federal grants for payments for individuals, for programs such as TANF and Medicaid, as well as rapidly accelerating costs in programs such as Medicaid, where rising health care costs were driving up federal and state spending.

The growth in federal outlays to state and local governments continues the trend of the changing nature of federal grants to state and local governments over time. Federal transfers have shifted from an emphasis on grants to state and local governments to an emphasis on grants for payments to individuals through federal programs administered by state and local governments. Both types of federal grant had increased steadily from the 1940s through the 1970s (see Figure 7.5). However, as grants to state and local governments began to be reduced in the early 1980s, grants for payments to individuals continued to increase. By 1987, payments for individuals surpassed grants to state and local governments. Since that time, federal transfers for grants for payments for individuals have continued to increase at a fast rate, while other grants to state and local governments have grown more slowly.

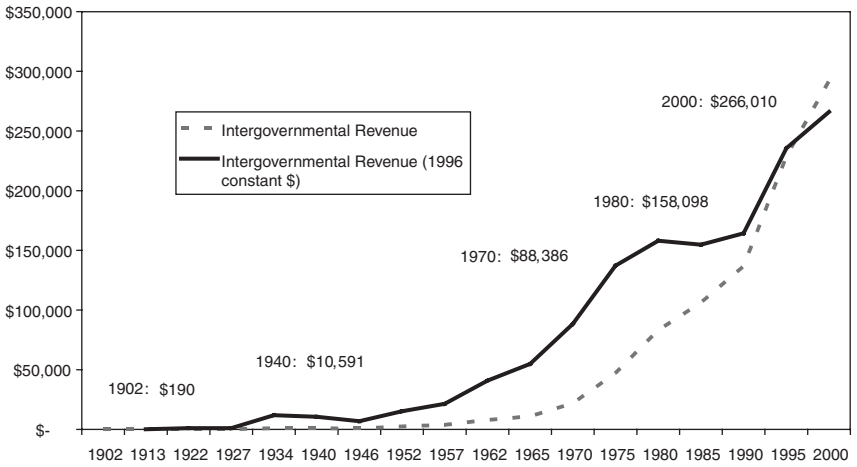
## State and local intergovernmental revenues

As with federal government spending, state and local spending has also increased substantially over the past century as the role of government in the US has expanded. Combined state and local government spending, in constant dollars, grew from \$37 billion in 1913 to \$1.6 trillion in 2000 (see Figure 7.6).

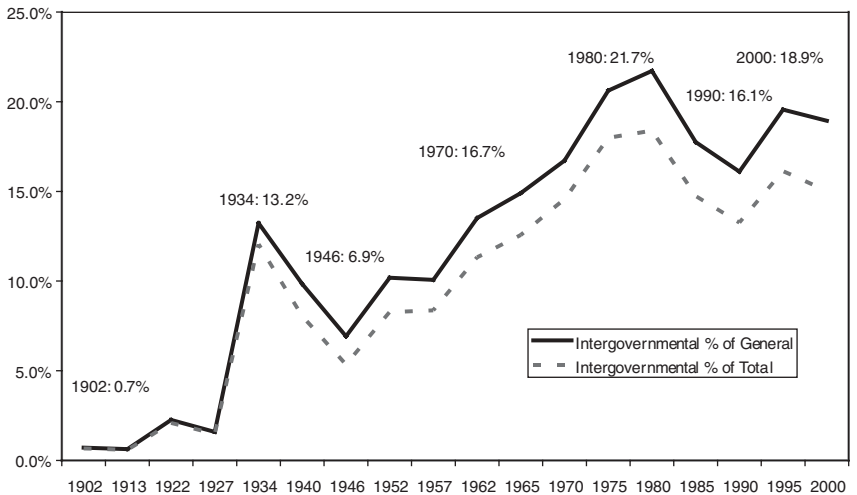


*Figure 7.6* State and local government expenditures, 1913–2000 (constant 1996 \$, millions)

*Sources:* US Department of Commerce, Bureau of the Census, Historical Statistics on Governmental Finances and Employment, 1982 Census of Governments, Vol. 6, No. 4 and Advisory Commission on Intergovernmental Relations, Significant Features of Fiscal Federalism, 1994, Vol. 2.



**Figure 7.7** State and local intergovernmental revenues, 1913–2000 (millions)  
*Sources:* US Department of Commerce, Bureau of the Census, Historical Statistics on Governmental Finances and Employment, 1982 Census of Governments, Vol. 6, No. 4; Advisory Commission on Intergovernmental Relations, Significant Features of Fiscal Federalism, 1994, Vol. 2; US Department of Commerce, Bureau of the Census, Governments Division.



**Figure 7.8** Intergovernmental revenues as a % of total and general state-local revenues, 1902–2000  
*Sources:* US Department of Commerce, Bureau of the Census, Historical Statistics on Governmental Finances and Employment, 1982 Census of Governments, Vol. 6, No. 4; Advisory Commission on Intergovernmental Relations, Significant Features of Fiscal Federalism, 1994, Vol. 2; US Department of Commerce, Bureau of the Census, Governments Division.

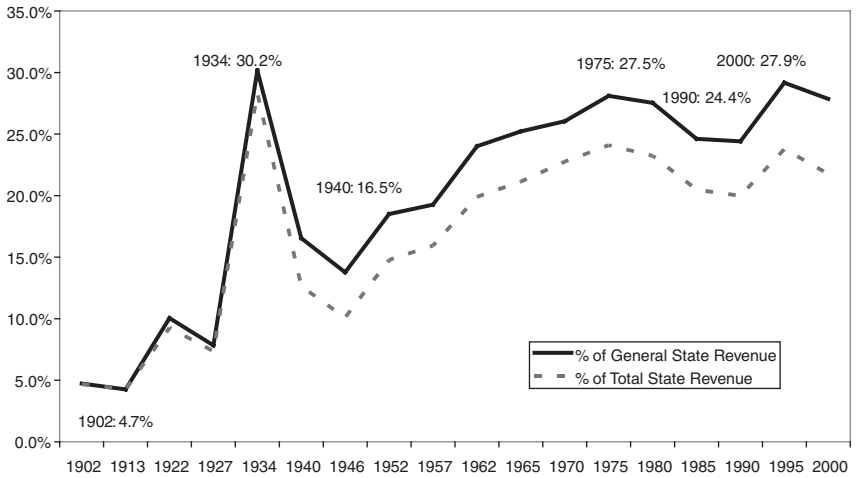
Intergovernmental revenues from the federal government also grew steadily over time. In constant dollars, state and local government revenues from the federal government increased from \$190 million in 1902 to \$10.5 billion by 1940, \$88.3 billion by 1970, and \$158 billion by 1980 (see Figure 7.7). After a short drop-off in the early 1980s (to \$154 billion), these revenues again began to grow, rising to \$266 billion by 2000.

As a percentage of general and total state-local revenues, transfers from the federal government steadily grew from the 1940s through 1980, rising from 6.9 percent in 1946 to 21.7 percent in 1980.<sup>5</sup> After 1980, as a result of reductions in grants to state and local governments and the elimination of GRS, the percentage dropped, falling to 16.1 percent by 1990. Since that time, some growth and leveling out has occurred, with intergovernmental revenues comprising 18.9 percent of general state-local revenues in 2000 (see Figure 7.8).

### **State spending and intergovernmental revenues**

Both state and local government spending, separately, have grown dramatically over the last century. State government spending increased from six billion dollars in 1913 to \$987 billion by 2000, in constant dollars (see Figure 7.6). Key changes in the balance of state-local spending between state governments and local governments occurred early and near the end of the last century. Early in the 1900s, the balance of state and local spending was heavily tilted in the local direction, with local spending accounting for 83 percent of total state-local spending. By 1940, however, state spending had increased its share of the total to 40 percent. By 1970, the state share had increased to 48 percent, and by 1995 and 2000 the state share of total state and local spending rose above 50 percent for the first time.

Intergovernmental revenues, the overwhelming majority provided by the federal government, increased steadily over time and most dramatically since the 1940s.<sup>6</sup> In constant dollars, intergovernmental transfers to state governments have increased from \$8.2 billion in 1940 to \$250 billion in 2000. As a percentage of total and general state revenues, however, the growth has not been as steady – particularly since 1980. Over the same period, intergovernmental revenues grew from one-sixth (16.5 percent) of state general revenues to more than one-quarter, peaking in mid-1970s at around 28 percent (27.5 percent in 1975). The reductions in federal transfers to state and local governments in the 1980s resulted in a declining share of state general revenues coming from intergovernmental transfers, falling to 24 percent by 1990. Growth in the intergovernmental share of state general revenues resumed in the 1990s, rising to its highest point in the mid- to late 1990s (29 percent in 1995), and leveling off at around 28 percent by 2000 (see Figure 7.9).



**Figure 7.9** Intergovernmental revenue as a % of state revenue, 1902–2000

Sources: US Department of Commerce, Bureau of the Census, Historical Statistics on Governmental Finances and Employment, 1982 Census of Governments, Vol. 6, No. 4; Advisory Commission on Intergovernmental Relations, Significant Features of Fiscal Federalism, 1994, Vol. 2; US Department of Commerce, Bureau of the Census, Governments Division.

### Local spending and intergovernmental revenues

Local government spending, as with federal and state spending, increased throughout the last century, rising from \$31 billion in 1913 to \$907 billion in 2000 in constant dollars (see Figure 7.6). Since the mid-1970s, the local share of total state and local government spending has approximated 50 percent.

Intergovernmental revenues, provided primarily by state governments and federal governments, also rose steadily from \$1.5 million in 1913 to \$318 billion, in constant dollars, by 2000. As with the trend for state governments, the percentage of local revenues derived from intergovernmental sources increased throughout the last century until approximately 1980, after which there was a brief decline followed by slight recovery. Intergovernmental revenues comprised merely 6.6 percent of local general revenues in 1902 (see Figure 7.10), growing to more than one-quarter of general revenues by 1940 (27.8 percent), and more than two-fifths by 1980 (44.1 percent). By 1990, the intergovernmental share had dropped to 37.2 percent, rising to 39.4 percent by 2000.

In contrast to state governments, the bulk of intergovernmental revenues at the local level are not derived from the federal government. Rather, as corporations of state governments, local governments are far more reliant upon state transfers and aid as a source of revenue. For the majority of the

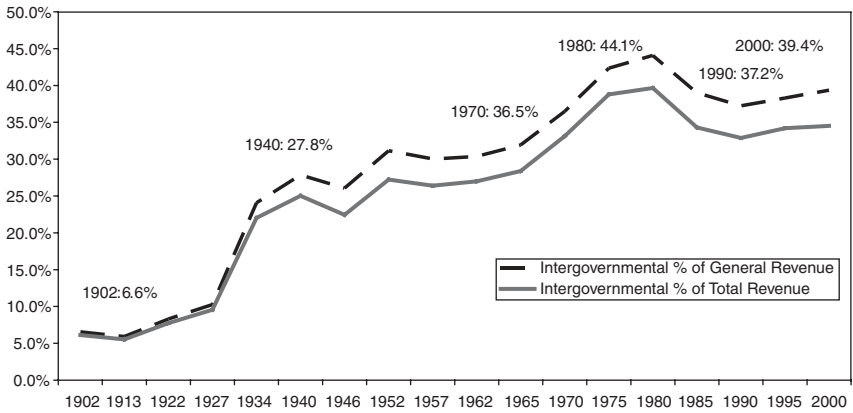
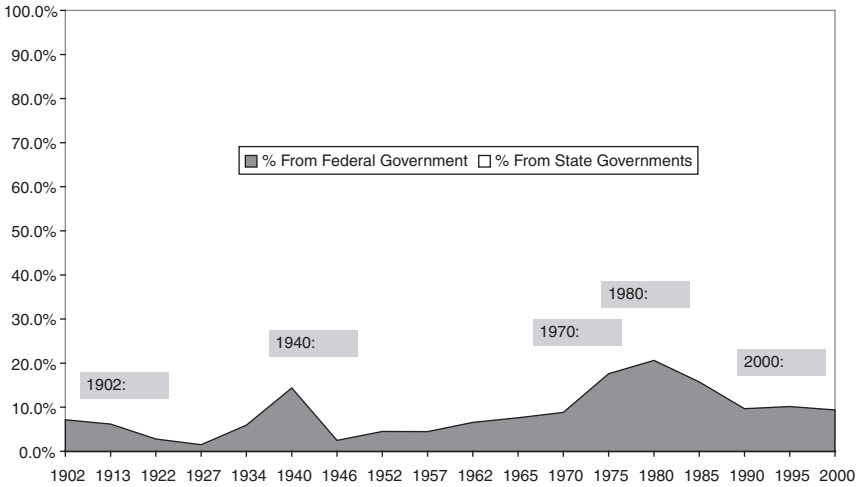


Figure 7.10 Intergovernmental revenue as a % of local revenues, 1902–2000

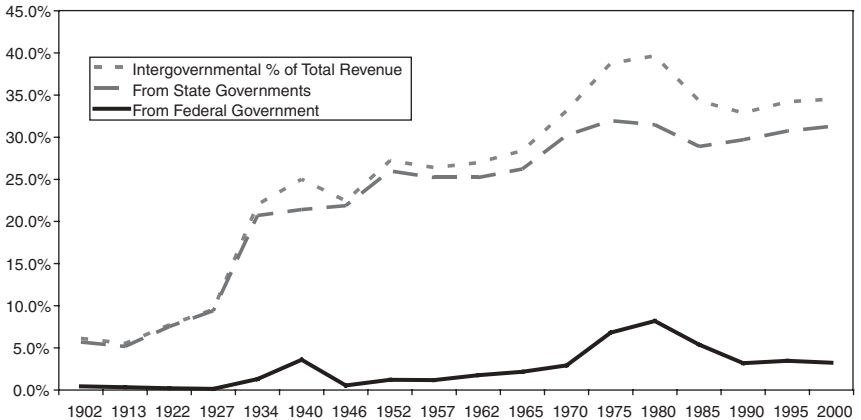
Sources: US Department of Commerce, Bureau of the Census, Historical Statistics on Governmental Finances and Employment, 1982 Census of Governments, Vol. 6, No. 4; Advisory Commission on Intergovernmental Relations, Significant Features of Fiscal Federalism, 1994, Vol. 2; US Department of Commerce, Bureau of the Census, Governments Division.

past century, state transfers accounted for approximately nine out of every ten intergovernmental revenues received by local governments. As a percentage of local intergovernmental revenues, state revenues comprised 92.9 percent in 1902, 85.6 percent in 1940, and 91.2 percent in 1970 (see Figure 7.11). The continued growth of federal programs in the 1960s and 1970s, however, resulted in a dramatic rise in the federal share of local intergovernmental revenues. By 1980, the federal share had risen to 20.6 percent, with the state share dropping to 79.4 percent. The cuts of the 1980s subsequently returned state and federal shares to their previous order, with the state share of local intergovernmental revenues climbing back to 90 percent by 1990.

One might expect that the transfer behavior of state governments and the federal government would counter each other over time – a rise in federal government transfers to local government resulting in a decline in state transfers, for example, during the 1960s and 1970s. In fact, the opposite is true. Federal and state government transfers tend to follow similar paths, usually because reductions in federal transfers to state governments tend to trigger similar responses at the state level as state governments seek to balance their budgets. In some cases, where the state simply passes federal funds on to local governments in an administrative role, the link between federal and state behavior is much more immediate and direct. The trend lines exhibited in Figure 7.12 show how intergovernmental transfers to local governments from state governments and the federal government followed similar courses over the past century.



**Figure 7.11** Local intergovernmental revenue: state and federal shares, 1902–2000  
*Sources:* US Census, Historical Statistics on Governmental Finances and Employment, 1982 Census of Governments; Advisory Commission on Intergovernmental Relations, Significant Features of Fiscal Federalism, 1994; US Census, Governments Division.



**Figure 7.12** Intergovernmental revenue as a % of total local revenue, 1902–2000 (millions)  
*Sources:* US Department of Commerce, Bureau of the Census, Historical Statistics on Governmental Finances and Employment, 1982 Census of Governments, Vol. 6, No. 4; Advisory Commission on Intergovernmental Relations, Significant Features of Fiscal Federalism, 1994, Vol. 2; US Department of Commerce, Bureau of the Census, Governments Division.

## Municipal revenues

The municipal portion of the local government story paints a particularly vivid picture of the changing trends in intergovernmental revenues over the past century. During that time, intergovernmental sources of revenue at the municipal level grew at a considerably slower rate than for other local governments. Intergovernmental revenue at the municipal level grew from \$253 million in 1932 to \$63 billion by 1997 in current dollars – growing by a factor of 250 (see Figure 7.13). In comparison, intergovernmental revenue for other local governments increased from \$558 million to \$224 billion over the same time period – growing by a factor of 400. Faster growth in intergovernmental transfers to non-municipal governments has occurred both at the federal and state levels (Hoene and Pagano 2003). As a percentage of total local intergovernmental revenues, the municipal share reached its lowest point in the late 1990s (21.9 percent in 1997), falling from a high point of 31.3 percent reached by 1977. In short, federal and state transfers to local governments have been skewed to non-municipal local governments, and the imbalance has increased over time.

Despite this imbalance, intergovernmental revenues were an increasingly important source of revenue for municipal governments for much of the last century. Intergovernmental revenue as a percentage of municipal general revenue grew from 9.5 percent in 1932 to 39.7 percent in 1977

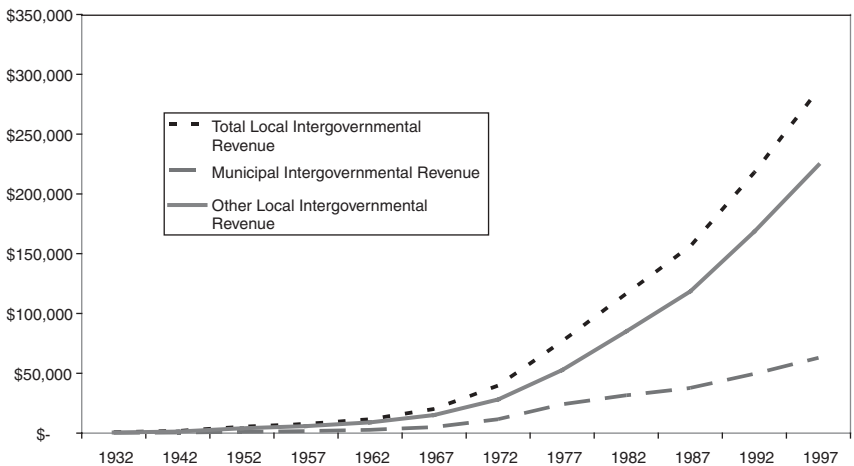


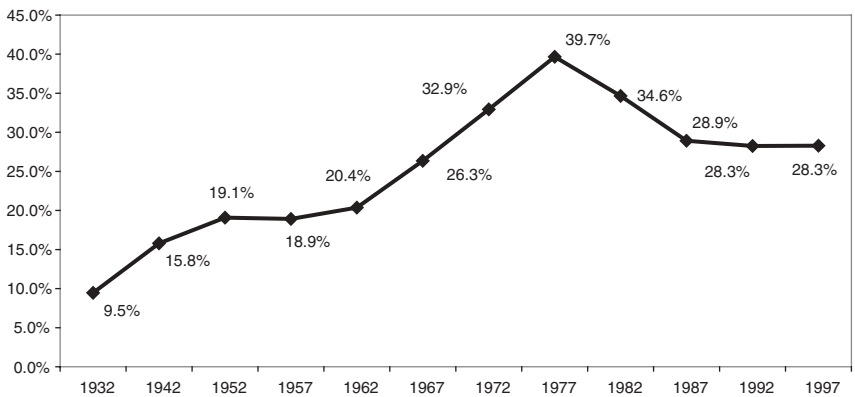
Figure 7.13 Local and municipal revenues from intergovernmental sources, 1932–97 (millions)

Sources: US Department of Commerce, Bureau of the Census, Historical Statistics on Governmental Finances and Employment, 1982 Census of Governments, Vol. 6, No. 4 and Compendium of Government Finances, 1987, 1992, and 1997 Census of Governments, Vol. 4, No. 5.



(see Figure 7.14), nearly doubling between 1962 (20.4 percent) and 1977 as federal and state transfers peaked under the Great Society-Creative Federalism programs of the 1960s and 1970s. Many of these programs provided funds directly to municipalities, particularly those in more urban and metropolitan areas. Reductions in and elimination of many of these programs in the 1980s subsequently led to a decline municipal reliance upon intergovernmental revenues in the latter quarter of the century – falling to 29 percent by 1987 and leveling off at approximately 28 percent by 1997.

Municipalities declining reliance upon intergovernmental transfers has, however, been primarily driven by the declining role of federal transfers, relative to the state role, over the past three decades. From 1972 to 1997, municipal general revenues from state transfers steadily increased from \$8.4 billion to \$45.4 billion. In contrast, federal transfers increased from \$2.5 billion to \$11.7 billion over the same time period, and actually decreased between 1982 (\$11 billion) and 1992 (\$8.1 billion). Here again, however the growth in federal transfers during the 1990s was fueled largely by federal grants for payments for individuals – not for municipal governments *per se* – a trend that affected both state and local governments, as noted earlier. As a result, the share of municipal intergovernmental revenues from the federal government has decreased since the peak period of the 1970s. After growing dramatically between 1972 (22 percent) and 1977 (37 percent), the federal share of municipal intergovernmental revenues dropped to 16.4 percent by 1992, leveling off at 18.6 percent by 1997. Meanwhile, the state share increased from 58.6 percent in 1977 to 73.1 percent by 1997, returning to its 1972 level (see Figure 7.15). As a



**Figure 7.14** Intergovernmental revenue as a % of municipal general revenue

Sources: US Department of Commerce, Bureau of the Census, Historical Statistics on Governmental Finances and Employment, 1982 Census of Governments, Vol. 6, No. 4 and Compendium of Government Finances, 1987, 1992, and 1997 Census of Governments, Vol. 4, No. 5.

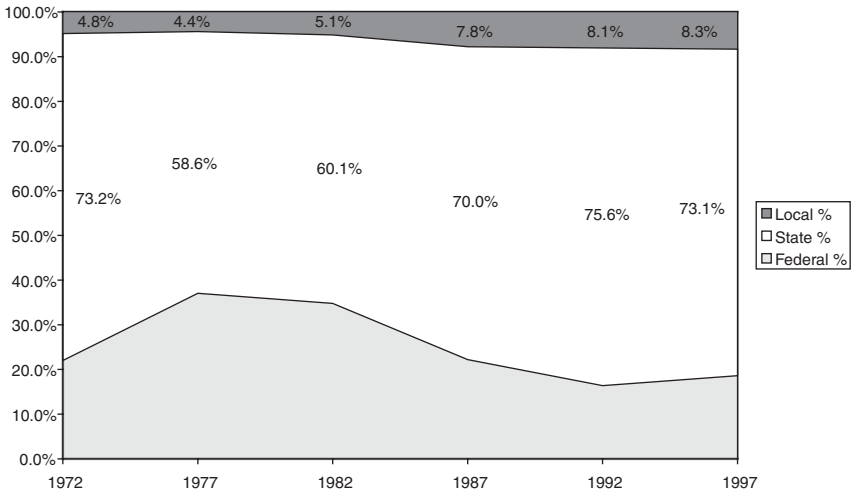


Figure 7.15 Intergovernmental shares of municipal general revenue, 1972–97

Sources: US Department of Commerce, Bureau of the Census, Historical Statistics on Governmental Finances and Employment, 1982 Census of Governments, Vol. 6, No. 4 and Compendium of Government Finances, 1987, 1992, and 1997 Census of Governments, Vol. 4, No. 5, US Bureau of the Census, Census of Governments, 1972–97.

share of total municipal general revenues, federal transfers have declined from nearly 15 percent in 1977, to 5 percent by 1997, while the state share has hovered at around 20 percent over the same period (Hoene and Pagano 2003).

In short, for municipal governments, the decline in federal transfers was most dramatic as the federal government moved away from programs providing direct aid to cities, both in terms of reducing and eliminating programs and in shifting emphasis toward programs that provide payments for individuals instead of places. At the same time, state transfers have grown or remained fairly stable as a source of municipal revenues. In both cases, however, the share of intergovernmental revenues flowing to municipalities, as opposed to other local governments, has been declining in recent periods.

## Mandates and preemptions

While the role of intergovernmental transfers and fiscal flows has been on the wane for the past two decades, it is important to note that the federal government has not simply been engaged in a process of disengaging itself from its federal and local counterparts. Instead, federal emphasis has shifted away from fiscal federalism and intergovernmental transfers to regulatory federalism through mandates and preemptions.

The rise of mandates and preemptions has been well chronicled. Mandates have become increasingly popular federal tools over the past 40 years. The number of major federal mandates on state and local governments increased from under ten in the period between 1955–64 to more than 40 from 1965–74, to over 80 between the period from 1975–84, and to more than 100 by 1985–94 (Nivola 2002). State and local government officials' major objection to mandates is not just the requirement of activity, or specification of how such activity should occur, but the fact that many of these mandates are often handed down without adequate funding, or any funding, from the federal government. The practice of unfunded and underfunded mandates often occurs in broad and sweeping form as the federal government seeks to enact large-scale policy reform even while lacking the fiscal capacity to fund such reform. The most recent example is the No Child Left Behind legislation passed by Congress and signed into law by President Bush in 2002. The legislation, requiring broad changes in school testing and curriculum at the state and local level, has yet to be funded in full.

Like mandates, preemptions have increased in practice in recent decades. The US Advisory Commission on Intergovernmental Relations (1995) found that more than half of all federal preemption statutes passed since 1789 were enacted after 1969. Preemption statutes proliferated, in particular, during the 1970s, 1980s, and 1990s. Nivola (2002) and the US General Accounting Office (2003) estimate that there were nearly 130 preemption statutes enacted in the 1990s, after more than 100 such statutes passed in both the 1970s and 1980s.

Local governments, as corporations of state governments, can point to similar trends in their relationships with state governments, particularly during times of economic downturn or when federal actions restrict funding or preempt state authority.

The rise of mandates and preemptions at the same time as intergovernmental flows began to decline created heightened levels of tension between the various levels of government – a situation characterized as the dismantling of the intergovernmental partnership (National League of Cities 2003) by local and state officials. These officials find themselves not only in the position of coping with less aid from higher levels of government, but with an increasing number of rules for how they provide services and restrictions on their authority to tailor policy locally or raise additional local revenues.

### **Tax and expenditure limitations (TEL's)**

Further complicating the messiness of the intergovernmental system at the state and local levels is the growth of tax and expenditure limitations (TEL's) over the past three decades. TEL's are an outgrowth of the so-called tax revolt that has predominated public discussions of tax policy in

the US since the late 1970s. Ignited by voter passage of Proposition 13 in California in 1978, capping local property tax rates and assessments, the tax revolt has led to many voter-imposed and state-imposed restrictions on state and local government's ability to raise revenues, levy taxes, raise tax rates, and increase spending (Kaufman and Rosen 1981; O'Sullivan *et al.* 1995; Chapman 1998).

TEL's typically take three forms – general restrictions on the ability of state and local governments to increase revenues from year to year, general restrictions on the ability of state and local governments to increase spending from year to year, and specific restrictions on local government property tax authority. Revenue and spending limitations usually apply to the annual growth in state and local government general-purpose revenues and expenditures, seeking to limit the overall size and activities of government or its abilities to raise taxes, and additional revenues, beyond a certain level. Property tax limitations typically cap the growth rate of the annual property tax rate (usually referred to as the mill rate), growth in assessed value of property, or the annual growth in revenues collected. All three TEL forms have been on the rise over the past two decades, enacted by state legislative action, voter initiative, or referendum. Property tax limits are nearly ubiquitous, with nearly every state now having some form of local property tax limit. Many of the more stringent property tax limits have, however, been enacted since 1978, following the precedent set by Proposition 13.

The issue of TEL's is important for several reasons. First, to the extent that state governments enact TEL's, they represent another form of restriction on local authority and fiscal capacity (Kincaid 1997). Regardless of how TEL's are enacted, they typically add to the complexity of relationships, fiscal flows, and responsibilities between state and local governments. For example, local property tax limits typically result in local governments being less able to finance existing service levels and states have often responded by taking over certain previously local responsibilities – thereby centralizing state authority. At the same time, restrictions on state budgets often result in states reducing transfers to local governments and, in some cases, taking away local revenue authority.

The State of California, after Proposition 13, exhibits these points in a number of ways. Proposition 13's restrictions on local property tax authority resulted in the threat of severe revenue losses and service cutbacks at the local government level, and essentially transferred control over allocation of local property taxes to the state government. In response, the California state government, operating with a budget surplus at the time, agreed to provide temporary fiscal relief to local governments, assume some previously local responsibilities, and allocate property tax revenues by a formula based upon previous years' allocations. The short-term mechanism for distributing state revenues, however, quickly became permanent as state legislators struggled with the need to resolve the responsibilities left to it by Proposition 13. Over

the next 25 years, the transfer of control to the state had a number of implications for future state-local fiscal relations. As one example, in the early 1990s, faced with a recession and its inability to balance its budget, the state transferred municipal, county, and special district property tax revenues away from these local governments to school districts in order to cover the state's required share of education funding. The state then partially backfilled city, county, and special district revenues with funds provided through state legislation to fund public safety programs. This temporary shift in funding streams subsequently became permanent, resulting in an annual shift of property tax revenues from other local governments to school districts and later state efforts to remedy the problem through other funding backfill efforts in non-tax revenue sources (Hoene 2001).

The California experience points to the burdensome and often absurd level of complexity added to an already complex intergovernmental system by TEL's and their progeny. Combined with other federal and state mandates and preemptions, and a general decline in intergovernmental transfers, the scenario created is one in which state and local governments are increasingly confronting structural fiscal crises – the inability to finance existing, and often required, commitments and responsibilities through existing, and restricted, sources of revenue. This is particularly the case for the past three decades.

The picture painted here of fiscal federalism and intergovernmental transfers is one of overall government expansion followed by a degree of retrenchment, particularly at the federal level. The expansion of the roles of government in the last century led to steady and dramatic growth in government spending at all levels of government, and similar growth in intergovernmental transfers between levels of government...that is, up through the late 1970s and early 1980s. The transition from the peak of government activity following the New Deal-Great Society-Creative Federalism programs to the New Federalism-Devolution focus of the early 1980s, represents a paradigm shift in American politics, for the American federal system, and for flows of revenue between levels of government. The fiscal federalism of the past two decades is usually described in negative terms – “coercive,” “combative,” “competitive,” “*de facto*” – descriptions of a system in which federal, state, and local governments are increasingly fending for themselves and turning inward, often at the expense of the others and the American people. It is highly unlikely that the American federal system will retrench all the way back to the dual federalism days of the pre-1930s. At the same time, it seems highly likely that the experiment of the past half-century will continue to be scaled back in some form, at least in the near term.

## **21<sup>st</sup> century American federalism**

The strength and the weakness of the American federal system lies in the fact that the intergovernmental relationships within the system are not

cleanly delineated or cast in stone. The system is inherently messy and changes over time. Depending upon the program, service arena, or moment in time, an assessment of the system might lead to the conclusion that it is centralizing or devolving, cooperative or competitive, new or old, or some combination of all of these descriptions.

It rarely matters what aspect of the system is under the microscope – there is some degree of messiness. For example, philosophical debate over whether the American federal system is more federal, in terms of operating as a loose association of states, or more national, in terms of centralizing power with the national government, is rather inconclusive. Consensus holds that the American system is a hybrid, combining elements of both systems depending upon what piece of the system being evaluated. Educated opinions of whether the federal, state, and local relationships are more cooperative or competitive also leave us with a sense that there are elements of each in different parts of the system, or that one description is more apt in a given time period. Similarly, analyses of whether intergovernmental transfers – revenues or authority – are adequate to meet service needs and demands, or incentivizing the intended behavior, depend upon what arena is scrutinized and when.

The overwhelming messiness of the system makes calls for a clearer separation of responsibilities and revenue streams seem, in theory, like sound policy advice. A sorting out of responsibilities and roles would seem to be in order after more than 200 years of tinkering, and in particular after the dramatic changes of the half-century. But, what if the messiness of the system is its single greatest strength? What if the lack of precision allows for opportunities and innovation, and perhaps most importantly, allows the system to adapt to changing circumstances and environments? We certainly have an abundance of evidence to make this case, not the least of which is the fact that the system endures today. A specific example is the strengthening of state governments as a result of the rise of federal government power in the 1960s and 1970s. Many state governments were criticized as lacking professionalism, unable or unwilling to address the expanding needs of their citizens, and in some cases explicitly discriminatory prior to this period. Federal involvement was subsequently encouraged as a means of addressing these deficiencies. Over the 1960s and 1970s, with considerable federal support and encouragement (sometimes unwelcome), the capacities of state governments rose dramatically. By the 1980s, when presidential and public opinion turned toward support for a smaller federal role, the states were in a position to provide leadership, take and expanded role, and in some cases offer innovative approaches to solving problems (Rivlin 1992a). The messiness that came with a stronger federal role, in this case, helped shape stronger state governments.

We may witness a similar phenomenon at the local, and particularly municipal, level amid the current changing of the system. Increased fiscal stress, induced by structural and intergovernmental problems, will likely

force local governments to turn inward in terms of looking toward innovative solutions locally. Interlocal and regional agreements, to save costs and take advantages of economies of scale, or to address problems intractable within one jurisdiction, will likely increase as local governments become less reliable on their state and federal counterparts. Economic forces such as globalization and the ease with which capital and people are mobile in the economy are also increasing the sense that cities and local governments are regionally tied together economically, creating more incentives for interlocal cooperation (Barnes and Ledebur 1998).

However, the complexity and messiness of the American federal system does pose some threats to the system's future. The single biggest threat is the lack of transparency in the system from the vantage point of the American public. Messiness, in this case, means that the average resident, citizen, or voter has a hard time understanding where their tax dollars are spent, for what, and what level of government is responsible. In a world where it seems people have less time for everything, taking the time to understand government becomes even more burdensome, and even less likely. The result is disengagement and a sense that government is not working – that government is wasteful, inefficient, and unable to address individual needs.

Public disillusionment with government leads then to another significant threat, one in which the public's perceptions are captured rhetorically and politically for the purpose of achieving policy objectives that might ultimately undermine the intergovernmental system. The policy debate in Washington, DC today is not about the state of American federalism. In fact, one is hard-pressed to find any recent reference to federalism within presidential and congressional settings. It is not insignificant that President Bush is the first US president since President Eisenhower to lack a major, publicly stated federalism agenda (Nathan *et al.* 2003). Behind the scenes, however, significant changes in intergovernmental arrangements are being proposed or underway – further block granting of social services (particularly services to lower income individuals and communities), reductions in funding for these services, and a continuation of the *de facto* devolution and regulatory federalism that characterized much of the past two decades. Familiar arguments are being made to justify these changes – the need for more state and local control and design, unwieldy federal programs, and the prospect of efficiency gains. But, these efforts, taken together, appear more directed at reducing the overall size and scale of government, and dismantling the intergovernmental system wherever it stands in the way.

These threats, to the extent that the messiness and complexity of the American federal system contribute to the problem, suggest that some degree of sorting out may indeed be in order. The question is how much of this is needed? Sorting out the roles and responsibilities of federal, state, and local governments for the sake of making the system more transparent

and accountable to the American people would seem to be the obvious and worthy goal. But, a distinction should be made between sorting out roles and separating revenue streams, or minimizing intergovernmental transfers. Sorting out roles and responsibilities may provide more transparency and efficiency – principles of sound public finance and good government. But, separating revenue streams, limiting the revenues generated by those streams, and reducing and minimizing the flow of intergovernmental revenues threatens the capacity of government to meet the needs of the American people. The ability to distinguish between maintaining the capacity of government (a revenue question), while sorting out responsibilities (a service delivery question) is key to the proposals outlined in President Nixon's New Federalism in the early 1970s and, in a similar way, in Rivlin's advocating for a rethinking of the American system (1992a). Both sets of ideas proposed a general framework where revenues would be collected and shared across levels of governments, but roles and responsibilities for crafting and delivering services would be more clearly delineated in accordance with the level of government best able to craft policies, often at the state and local levels. This framework would seem to be one worth pursuing, but it is not the course of American federalism today, nor has it been for the past 25 years.

## Notes

- 1 The use of the term *federal* takes on two meanings. One refers to the federal system of governance whereby powers and authorities are separated across levels of government. A second refers to the national government of the United States. Which meaning is implied here should be clear from the context.
- 2 The use of the term *local governments* here is generally meant to refer to general-purpose local governments – municipalities and counties primarily. The term may also refer to other local government forms, including school districts and special districts. Local governments are, by law, corporations of state governments and therefore not protected under the US Constitution. While not constitutionally apportioned, local governments have nevertheless become the third rail of the American federal system (Pagano 2003) – the source of energy that keeps the system moving as the implementers and ground-level designers of policies enacted at higher levels of government. As of 2002, there were 87,849 local government units in the United States, 38,971 of which are general-purpose local governments – 3,034 county governments, 19,431 municipalities, and 16,506 township governments. The remainder are special purpose local governments – 13,522 school district governments and 35,356 special district governments (US Census 2002).
- 3 National referring to the alternative form of government system to federalism as considered by the framers, involving a more unitary and centralized form of government.
- 4 Constant dollars are calculated in 1996 dollars throughout this analysis.
- 5 General revenues represent the primary annual operating funds for cities.
- 6 State governments also receive intergovernmental transfers from local governments, but the total is minimal in comparison to federal transfers.



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## **Part III**

# **The Policy Framework**

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# Overview and Introduction

*Sarah F. Liebschutz*

“There is always a well-known solution to every human problem – neat, plausible, and wrong,” H.L. Mencken, an American journalist, once observed.<sup>1</sup> The authors of the following chapters on the federalism policy framework do not make that mistake. They all make quite clear that formulating, funding, and implementing public services within a federal system is anything but neat and plausible. Rather than make even more complex these matters within what Susan Clarke has characterized in Chapter 3 in this book as “many federalisms,” my purpose is to present a broad framework encompassing all three chapters, and, in so doing, to show how each represents a valuable and distinctive perspective on the policy framework.

Defining federalism is a first challenge. Daniel Elazar’s generic definition – “self-rule plus shared rule” captures the dual needs of people and polities who chose federal systems “to unite for common purposes,” and also to “remain separate to preserve their respective identities.”<sup>2</sup> Federalism has both *political* and *governance* dimensions. As a political principle, federalism emphasizes the consensual basis of the polity, that is, the identification of citizens with the nation. As a governance principle, federalism assumes that:

1. powers are divided between national and subnational or regional governments, and that
2. the powers of the regional governments are consequential, not trivial.

The latter condition is necessary to differentiate between federal and decentralized systems.

William Riker, arguing from the American experience under confederation, asked, “Why would framers of constitutions adopt so difficult a political form?”<sup>3</sup> His answer was that the federal form “enables the rulers of a set of independent states to accomplish some objective that is not feasible independently or in alliance.”<sup>4</sup> He elaborates, in particular, that federation is a good device to implement two external motives – military, in the

aggregation of resources for war, and trade, in imposing restrictions against other nations. Other federalism scholars have noted the desire for greater autonomy by regions or states, such as in India and Spain, as a response to the “why federalism” question.<sup>5</sup>

Federalism, however, is more than a formal, legal structure composing national and subnational governments – in the American case, national, state, and local governments – to implement externally-focused goals. It is the internal dimension of the federal framework that is of particular interest to Carol S. Weissert, Daphne Kenyon, and Robert Agranoff. This is the dimension within which these governments “constantly interact to redefine their roles and responsibilities as social and economic conditions and political expectations change.”<sup>6</sup> To differentiate the formal structure from its dynamic reality, we use the term *intergovernmental relations* (or *intergovernmental disputes*) “to emphasize those actions and interactions among interdependent units of government.”<sup>7</sup>

Why do intergovernmental disputes, not harmony, abound? Some contend that disputes among the constituent units of a federal system “are inherently necessary.”<sup>8</sup> In fact, it has been observed that “if there are no disputes, then either the federal system has been fully unified or it has collapsed.”<sup>9</sup> Why are disputes necessary? The fundamental explanation is that governmental units (central and subnational) are mutually dependent; they are the component units of a symbiotic relationship. Why are disputes continuous? The answer to that question is embedded in the ongoing need to make readjustments to the authority of state, local, or national governments. At its core, a federal system is inherently dynamic.<sup>10</sup>

Of the three chapters, Carol S. Weissert takes the broadest perspective in sorting out roles and responsibilities among national and state governments in the United States. She traces, impressively, for a period of more than 200 years, historical, judicial, economic and political responses to the question, “Which government is best suited to carry out which domestic policy function?” She concludes that a positive (who does what?) focus rather than a normative (who should do what?) approach may lead to better understanding and better ways to think about federalism. Her prescription that combines rational choice models with empirical assessments is a reasonable way to think about the inherently dynamic, symbiotic system – not only the American but other federal systems as well.

Daphne Kenyon further sharpens our understanding of policy implementation choices, with a focus, in her words, “on delivery or production alternatives for goods and services that should be provided by government.” She presents a thorough and sophisticated array of mechanisms available to governments – through governmental, private for-profit, and private non-profit organizations. She illustrates through examples and a case study of elementary and secondary education in the United States, the tremendous

diversity in service-delivery alternatives available and used in the American states. Her conclusion that the wide choices of service-delivery alternatives and knowledge of experiences by governments with them can increase the probability of success, is well buttressed by her data.

Robert Agranoff's chapter is notable for its scope and breadth of empirical data concerning the management of intergovernmental policies. Intergovernmental management, in his words, is "an action-oriented intergovernmental process, transacting the routines of program through making legal-jurisdictional, political, technical, and task or project-based adjustments to fit policies into real situations." He presents data for 12 federal systems comparing the exercise of power – exclusive to the national or state governments and shared between them – over a wide range of welfare policy areas; considers horizontal and vertical formal and informal linkages among public managers; discusses mechanisms used in parliamentary systems; and presents case studies that demonstrate interactions among federal, state, local, and private sector interactions. In brief, Agranoff makes more complex the simple trinity of policy-making, funding, and administration that occur in implementation of intergovernmental policies, and does so with a clear appreciation for the centrality of bargaining.

Federal systems, and the American case in particular, as these three chapters demonstrate, tend to yield policy fragmentation – as inputs in policy formulation and as outputs in policy implementation. This is understandable. The interests of local, state, and national governments, for the most part, lack conceptual clarity. The mutual dependence of these governmental units further muddies the water. As these authors show, however, rational actors – public administrators and elected officials – representing all three governmental levels, recognize that their roles are to function within and perpetuate the inherently dynamic federal system.

Are the public policies – laws, judicial decisions, regulations – reasonable? Are they equitable? Are they effective? Do they meet criteria beyond satisfying the participant actors? Do they advance external motives for which the system was organized in the first place? These are the ultimate tests of policy-making in a federal system.

## Notes

- 1 H.L. Mencken, *Prejudices: Second Series, 1920* (New York: A.A. Knopf, 1924).
- 2 Daniel J. Elazar, *American Federalism: A View from the States* (New York: Harper and Row, 1984), 12, 33.
- 3 William H. Riker, "European Federalism: The Lessons of Past Experience," in *Federalizing Europe: The Costs, Benefits and Preconditions of Federal Political Systems*, Joachim Jens Hesse and Vincent Wright (eds) (New York: Oxford University Press, 1996), 11.
- 4 *Ibid.*
- 5 See the Introduction to Part I by Celina Maria de Souza Motta.

- 6 Sarah F. Liebschutz, "Intergovernmental Relations: The Dynamic Reality of American Federalism," *American Bar Association Update on Law-Related Education* 19: (1995): 15–16.
- 7 *Ibid.*
- 8 Riker, *The Development of American Federalism* (Nowel, MA: Kluwart, 1987), 74.
- 9 *Ibid.*
- 10 Liebschutz, *Bargaining Under Federalism: Contemporary New York* (Albany, NY: State University of New York Press, 1991), 7.

# 8

## Dividing the Job Revisited: Learning from the United States Case 1789–2006

*Carol S. Weissert*

It is not by the consolidation, or concentration of powers, but by their distribution that good government is effected.

Thomas Jefferson<sup>1</sup>

Little over a decade ago, a well-known US economist and practicing political scientist, Alice Rivlin, argued that the time had come (again) to rethink dividing the job of public policy between federal and state government (Rivlin 1992a, 1992b). She argued that reopening in the 1990s “the more than 200 year-old question of the desirable division of responsibilities between the states and the federal government” (1992b: 315) was necessary because (1) the federal government’s attention should be focused primarily on global interdependence; (2) policies needed to revitalize the economy should come from states; (3) states are competent and responsive enough to take on this task, and (4) the current system leads to citizen confusion over which level of government does what. She asserted that the federal government “has taken on too much responsibility and should return some of its functions to the states. A clearer division of responsibilities between states and the federal government could make both levels operate more effectively.” (1992a: 82). She proposed that the federal government take responsibility for health care financing, the states take charge of a “productivity” agenda of reforms in education and skills training, child care, housing, infrastructure and economic development, and states work together to adopt a common tax as a way of stabilizing and improving their financing role.

Although Rivlin’s call was well publicized and she later became a leader in the Clinton Administration, heading the Office of Management and Budget, it fell on deaf ears and little was accomplished.<sup>2</sup> Yet the rationale persists and arguably is needed more today than in 1992.<sup>3</sup>

The division of powers between national and state governments in the United States has been analyzed, critiqued, and targeted for reform for generations. Anton (1989) argues that the “essential federalism question is



which government should undertake which activity, and on whose budget?" (p. 10). Few disagree that the issue is important and crucial to the understanding and implementation of federalism. Clearly the US constitution delegates and enumerates the powers of the national government and reserves other powers to the states. But what is that division of power and can it even be categorized for use by politicians and other policy-makers? This chapter will build on the Rivlin call, focusing primarily on the political science rationale and approach and providing a historical overview and context for dividing the job revisited. It concludes with a number of factors that should be included in our thinking and calls for a new approach to incorporating them.

### **Dividing powers: the federal "principle"**

The division of powers between national and state governments in the United States is part and parcel of the definition of federalism. For example, Anton (1989: 3) defines federalism as a system of rules for the *division of public policy responsibilities* (my italics) among a number of autonomous governmental agencies. Michael Reagan (1972) says the "formal theory of federalism...stresses the independence of each level from the other, and the idea that the functions of government are divided so that some (e.g., defense) are exclusively the province of the central government while others (e.g., education, police protection) belong exclusively to the regional units" (p. 9).

Reagan's definition primarily fits the idea of "dual federalism" where governments have their own separate responsibilities. While perhaps an ideal, realistically there is more sharing of responsibilities, as first noted by Grodzins (1966) and dubbed cooperative federalism, where federal and state governments shared program responsibilities in large part through the mechanism of intergovernmental grants. Kincaid (1990) added a third conceptual overlay: coercive federalism in which the federal government increased the use of regulatory tools and preemption to coerce states and localities to do its bidding.

The independence of each level gets at the essence of dividing up the job. K.C. Wheare called the method of dividing powers so that the general and regional governments are each, within a sphere, coordinate and independent of the "federal principle" (cited in Reagan 1972: 7).

Delineation of this federal principle has occupied considerable time of academics, commissions, and politicians over the course of US history. Their contributions are analyzed below. However, there have long been dissenters to the idea of the federal principle. One of the earliest was Rufus Davis, who in 1967, argued that there is "neither science nor theory" in assigning governmental responsibility because federal constitutions are "political bargains," resulting from "political horse-trading"

that deliberately contains ambiguity (p. 9). Certainly the US constitution is a case in point regarding its ambiguous allocation “rules.” Davis believed that the real issue involves the implementation of those responsibilities and those depend on what the governments choose to do and the judicial response. These change over time.

Davis discounts Wheare’s federal “principle,” of distributing functions – that those matters of “national” “general” or “common” interest should be vested in the central government, while matters of a “local” or “particular” interest should be left in the hands of the regional governments because he says there is no clear answer to distinguish national from local (p. 3). He concludes his argument with the idea that “members of the federal state are free to pursue what ends they choose, and in what manner they choose, *providing they do not ‘destroy, limit, encroach’ upon the sphere of each other*” (p. 12, italics in original). To do so, governments must have “the financial means to be master, and the political ability to be master” (p. 15). He continues, “At best the federal compact can only be a formalized transaction of a moment in the history of a particular community” (p. 31).

## The federal principle in historical perspective

Issues surrounding the division of power and responsibilities between the national government and the states are as old as the United States. Indeed, the country’s founding fathers deliberately established the federal system to share responsibilities in a way that both levels would be strong and serve as a “check on each other.” One of the earliest (and most important) Supreme Court decisions – *McCulloch v. Maryland* (1819) – dealt with this issue – developing the idea of “implied powers” and freeing up the national government to take on duties not specifically described in the constitution but rather “implied” from it.

## Supreme Court clarifications

The US Supreme Court took on the allocation of responsibility issue intermittently throughout the decades.

In a 1851 US Supreme Court decision, Justice Curtis proposed some tests to decide what is a national or local responsibility. He proposed four “situations:”

- where the nature of the thing to be regulated, or the end to be achieved, imperatively demands a single, nation-wide uniform rule;
- where a national uniform rule would be desirable, but in which local variations are not intolerable;
- where there would be a “superior fitness and propriety” to local rules adapted to the needs of the locality and circumstances; and

- where the conditions “imperatively demand” or require as an “absolute necessity” a diversity of rules (*Cooley v. Board of Wardens of Philadelphia*, 12 Howard 299. Quoted in Davis 1967: 3)

The Curtis “situations” could be arrayed on a continuum with the single nation-wide, uniform national goals on one end and local diversity of rules as an absolute necessity at the other. It is the issues between the two extremes that the court has struggled with over the years, especially those where national rule is desirable but local variations are not intolerable. In other cases the Taney Court (1835–63) broadly defined states’ police powers in areas dealing with public health, safety and good order. Over the next 60 years, the states were the primary provider of education, welfare, hospitals, police and sanitation. Even in the more expansive years of the court beginning in the 1930s, most of the new federally funded activities and responsibilities were those that the states could not have accomplished and the states’ police power continued to expand with the imprimatur of the US Supreme Court. However, continued pro-national interpretations of the commerce and conditional spending clauses and an activist interpretation of the 14<sup>th</sup> amendment, especially concerning civil rights, led to a steady enhancement of national authority, especially in the Warren Court years (1960–69) and to a lesser extent the Burger Court years (1969–86) (Walker 2000).

In 1976, the US Supreme Court stepped into the allocation arena with *National League of Cities v. Usery* (426 US 833 1976). in which the court by a 5–4 majority overturned a federal law extending national fair labor standards to wage and hours provisions of most state and local employees. In this case the court differentiated between “traditional” and “non-traditional” state functions and said that states had discretion to structure “traditional” governmental functions important to the states’ separate and independent existence. The majority held that the extension of national fair labor standards constituted a violation of the states’ traditional governmental functions. While not defining “traditional governmental functions,” Justice Rehnquist, who wrote the majority opinion, listed possible traditional functions as fire protection, policy protection, public health and parks and recreation (Anton p. 14).

However, trying to decide which functions were and were not traditional functions turned out to be a difficult task for the Court in the ensuing years. Decisions “clarified” the situation by holding that regulating ambulance services, licensing drivers, operating a municipal airport or highway authority were “traditional” while regulation of traffic on public roads and air transportation, operating a mental health center and providing domestic services to the aged and handicapped were “non-traditional” (Anton p. 14). In *Garcia v. San Antonio Metropolitan Transit*

*Authority* (105 S. Ct. 1005, 1011) a 1985 case involving a Texas bus company, the court threw up its hands, saying:

We find it difficult, if not impossible, to identify an organizing principle that places each of the cases in the first group on one side of the line and each of the cases in the second group on the other side. The constitutional distinction between licensing drivers and regulating traffic, for example, or between operating a highway authority and operating a mental facility, is elusive at best (cited in Anton p. 14).

Justice Blackmun writing for the majority concluded that the “essence of our federal system is that within the realm of authority left open to them under the Constitution, the States must be equally free to engage in any activity that their citizens choose for the common weal, no matter how unorthodox or unnecessary anyone else – including the judiciary – deems state involvement to be” (cited in Anton p. 15).

The majority decision (in another 5–4 case) continued on to say that there were no constitutionally protected powers of state sovereignty, no discrete limitations on the objects of federal authority other than the provision granting states a role in the selection of Congress and the president. The court said that if there were “limits on the Federal Government’s power to interfere with state functions...one must look elsewhere to find them” (cited in Walker 2000 p. 187). Justice Blackmun said states could rely on two safeguards: structural (state role in selection of federal governments’ legislative and executive branches) and political (states’ success at getting funds for local services and their ability to get themselves exempted from obligations imposed by various federal laws).

In the following decades, the court stayed away from “defining” intergovernmental roles but was active in forcing Congress to clarify the justification of federal responsibilities and more importantly, the justification for forcing states to pass legislation fulfilling federal purposes (Weissert and Schram 2000).<sup>4</sup>

So while the current court is actively engaged in redefining federalism in many ways, it continues to sidestep the responsibility for defining what level of government should do what.

## **Commissions, committees and advisory groups**

Bringing experts and differing interests together to come up with answers to tough policy questions is a longstanding and popular American choice. Ignoring that advice is similarly longstanding and popular. The “who does what” question is just the sort of thorny policy that is grist for the advisory commission mill. Over the past 50 years, there have been numerous studies and reports in this area.

Among the first was the Commission on Intergovernmental Relations, established by President Eisenhower in 1953 to study the proper role of the Federal Government in relation to the states and their political subdivisions. It considered situations where conditions justified national action including: (1) when the national government is the only agency that can summon the resources needed for an activity; (2) when the activity cannot be handled within the geographic and jurisdictional limits of smaller government units; (3) when the activity requires a nation-wide uniformity of policy that must be achieved by interstate action; (4) when a state through action or inaction does injury to the people of other states; (5) when states fail to respect or protect basic political and civil rights that apply throughout the United States. One of the Commission's recommendations was the establishment of a staff agency within the federal government to further develop guidelines for determining the conditions and circumstances justifying national action (Commission on Intergovernmental Relations 1955).

The US Advisory Commission on Intergovernmental Relations (ACIR) was set up by the Congress in 1959 with one of its purposes to "recommend, within the framework of the Constitution, the most desirable allocation of governmental functions, responsibilities, and revenues among the several levels of government...."<sup>5</sup> An early ACIR report (1969) called for federal assumption of full financial responsibility for public assistance including welfare and Medicaid.<sup>6</sup> Over the years, the Commission adopted five standards of assessment of responsibilities of the national government: national purpose, economic efficiency, fiscal equity, political accountability, and administrative effectiveness (ACIR 1981). In 1981, the Commission felt the national government had gone beyond the criteria, particularly in their application to federal grants in aid, generally because of the substitution of short-term political judgment for a clear application of theory and concern for balanced federalism.

In the 1980s, the ACIR dealt directly with the issue of intergovernmental balance in a 14-volume series in which it concluded that the intergovernmental system had grown "more pervasive, more intrusive, more unmanageable, more ineffective, more costly, and above all, more unaccountable." (ACIR 1981: 101) It later took on the issue of regulatory federalism in another multi-volume analysis. Also in that decade, several one-time commissions were convened to examine functional federalism. (Interestingly, several individual governors were very vocal and articulate in arguing for the sorting out of functions. Republican Governors Lamar Alexander of Tennessee and Richard Snelling of Vermont and Democratic Governor Bruce Babbitt of Arizona made a number of appeals to their colleagues, to Washington and to the press.)

The Committee on Federalism and National Purpose was convened in 1984 and issued a report in 1985 in which it agreed "on the necessity for greater separation of responsibilities" (between states and the national

government) – a view similar to that of the president (Reagan) who established the committee (Anton 1989). While concluding that there are no hard and fast rules about which levels of government can perform which functions best, they did suggest that the national government assume greater financial responsibility for welfare and states assume full financial, policy, and administrative responsibility for many community development, local infrastructure and social services programs (National Conference of Social Welfare 1985).

A year later, a Working Group on Federalism of the Reagan Domestic Policy Council called for a strict interpretation of the constitutional principles, essentially, “a system of government in which the national government exercises sovereign authority in accord with the letter, and the limits, of its constitutionally enumerated powers, and the states exercise sovereignty authority in all other areas.” (cited in Anton p. 228).

Sorting out the federal system – particularly concern that the federal government was taking on too many responsibilities – was the focus of two conferences sponsored by major interest groups representing state officials in the 1990s. The recommendations of both concerned ways to limit federal preemption and maximize state-local discretion – rather than rethinking the roles (see Weissert and Schram 1996, 1998).

The impact of these commissions, committees and conferences was slight. The Reagan-era groups largely mirrored his concern for shedding national responsibilities (and costs). The ACIR work was important but focused more on the impact of the top-heavy dominance in intergovernmental relations than on the criteria for sorting functions. Its criteria – including political accountability and administrative effectiveness – were not widely discussed. The 1990s conferences were noteworthy primarily in the controversy and fear they aroused in some who feared they would recommend a revisiting, possibly a revamping, of constitutional provisions. Little new thinking emerged.

## Presidential leadership

It might appear that state responsibilities would have been enhanced politically by the string of former governors who have recently inhabited the White House beginning with Jimmy Carter elected in 1976.<sup>7</sup> Four of the five most recent presidents came to the White House having served from governor of Georgia, California, Arkansas, and Texas. Two of the governors (Carter and Clinton) were very active in the National Governors Association and one (G.W. Bush) was elected with strong support from the governors. However, ironically, only one governor turned president (Reagan) had a goal to sort out intergovernmental responsibilities which he believed had “become a confused mess.”<sup>8</sup>

President Reagan supported a plan where the federal responsibilities would be confined to those functions that only the national government can undertake such as national security and (interestingly) Medicaid, the national federal-state health program for the poor. This left for the states most of the federal government's domestic responsibilities in welfare, transportation, economic development and the environment. States could do this through gradually assuming full responsibility for 43 federally aided programs in education, health, social services, community development and transportation.<sup>9</sup> In hindsight, 20 years later, it is apparent that the states should have jumped on the opportunity. The growth in Medicaid has far outstripped that of welfare and the latter has been transformed into a block grant maximizing state discretion. Ironically, much of the opposition in 1981–82 concerned devolving welfare and the inequity that might entail – what in fact, has occurred with the adoption of the 1996 welfare reform law.

President Reagan's 1987 Executive Order called on federal agencies to defer to state discretion whenever possible since "in most areas of governmental concern, the States uniquely possess the constitutional authority, the resources, and the competence to discern the sentiments of the people and to govern accordingly" (cited in Donahue 1997: 42). However as Conlan (1998) notes, the Reagan rhetoric far outpaced action since Reagan "consistently favored federal over state and local authority whenever the former was more supportive of free markets or private sector interests" (p. 296).

Bill Clinton's White House made one effort to help define governmental responsibilities, and it was not well received. The 1998 executive order provided criteria for policy-making for federal agencies that was broad and geared toward proactive federal action. In addition to justifying federal action on interstate issues or where there is a need for uniform national uniformity, the criteria included "when decentralization increases the costs of government thus imposing additional burdens on the taxpayer" and "when States would be reluctant to impose necessary regulations because of fears that regulated business activity will relocate to other States." The outcry from state and local governmental lobbies caused a repeal of the executive order and a replacement with one that called for "strict adherence to constitutional principles" (Derthick 2000: 27).

In the mid-1990s, it was the Republican Congress, not the Democratic president, that promoted a major policy change involving a shift in responsibilities. The 1996 welfare reform bill changed welfare from an entitlement to a block grant and provided some additional flexibility for states but in the end, it was a change in grant form, not any clear "handing off" of responsibilities. Perhaps because of this, there was little discussion of the functional allocation of redistributive responsibility of welfare during the congressional debate (see, for example, Winston 2002).

In the 1990s welfare reform and an unfunded mandates bill were the tangible products of what was dubbed “The Devolution Revolution.” The term caught on and became the focus of articles, conferences, and political dialogue. The idea was that federal politicians would in fact assess what functions could best be served at the local level and would “devolve” some of the authority they had captured to lower levels. Although both presidential candidates in 2000 were trying to present themselves as federalism-friendly (Bowman 2002), President Bush – like most of his predecessors – failed to act on the rhetoric. In the two terms of George W. Bush, there was no concern with rationalizing or “sorting out” of domestic programs and functions that characterized at least the rhetoric of earlier presidents. Further, in environmental protection, education, health care and public safety, new federal initiatives launched or supported by the Bush Administration made substantial incursions into policy areas once occupied solely or primarily by states (Dinan and Krane 2006).

### **Fiscal federalism**

Economists were among the first academics to weigh in on the issue of what governments should do what in a subfield that has become known as fiscal federalism. As Wallace Oates (1999) put it, “(W)e need to understand which functions and instruments are best centralized and which are best placed in the sphere of decentralized levels of government (p. 1120). To this day, Musgrave’s three-part division of governmental responsibility remains an important component in fiscal federalism. Musgrave (1959) posited that government functions could be divided into three groupings: stabilization, distribution and allocation. Stabilization related to monetary and fiscal policy and was best performed by the national government. Distribution services provide resources to those who are unable to achieve a satisfactory level of resources on their own. This too is best performed by the national government since if state or local governments provide redistributive services, those who will pay and who will not benefit exit the jurisdiction while attracting those who will benefit and not pay. Allocation relates to the division of resources between public and private goods; all governments participate in this function.

ACIR and other groups were influenced by these tenets. Peterson *et al.* (1986) built on the work of Musgrave and others by examining a number of intergovernmental health, education and housing programs over time and concluding that the national government should assume greater responsibility for redistributive programs and give states and local government a larger role in “developmental” programs, those intended to improve the economic position of a community in its competition with other areas.



Efficiency can also be viewed as a component of fiscal federalism. Efficiency can come from economies of scale (where a larger unit can provide service more cheaply than smaller one) or from provision by the lowest level of government which can respond quickly and effectively to its citizens' preferences. Tiebout (1956) developed what he called a "pure theory of local expenditure" and argued that local governments compete for taxpayers through their package of services and taxes. In turn, taxpayers demonstrate their demand for those goods through their residential location. To combine the Musgrave and Tiebout ideas, the national government should provide stabilization and redistribution while many local governments compete for allocation services. Considerable academic study has dealt with this idea of interjurisdictional competition (see for example, E. Ostrom 1990; V. Ostrom 1987; Kenyon 1991). President Richard Nixon's approach to federalism was more along these lines. He proposed a rational sorting out of functional responsibilities of various governmental levels to make government more effective and creative (p. 293).

President Reagan in the 1980s and Congressional Republicans in the 1990s essentially made this argument in their belief that governments closer to the people are more responsive to popular sentiment and more likely to constrain the growth of those programs (Weaver 1996). While the empirical evidence on this is not persuasive, the ideology consistently trumps research and the modern intergovernmental myth of devolving programs as a way of reducing spending continues to spread.

Calls for devolution in the 1990s led to a reexamination of the federal-state division of responsibility including Rivlin's. Interestingly, Rivlin argues more like a political scientist than an economist – harkening to institutional capacities and constraints as important rationales. She argues that the federal government cannot take on additional public investment in skills and infrastructure without a tax increase and that top-down management is unlikely to bring about needed change in education, skills training and related areas (interestingly, the No Child Left Behind law of 2001, strongly supported by the Bush Administration, attempts to do just that). She argues that the federal government should do what it can do well – providing the nation's social insurance system (adding a national role for providing health insurance) and states should take charge of what she calls the productivity agenda – education, training, infrastructure, economic development. Ironically, her plan sounded very similar to the earlier Reagan "swap" and turnback proposal.

Fiscal federalism also provides a mechanism for answering the "who should pay" question. Beneficiaries should pay for their services where possible. In an ideal world portrayed by Tiebout (1956), there would be multiple local governments producing the public goods desired by the citizens of that jurisdiction. Where beneficiaries cannot pay or where there are jurisdictional spillovers of benefits, the higher-level government should pay.

Intergovernmental grants can also help alleviate what Oates (1972) calls the “imperfect correspondence” between the government that provides a particular good and where those who benefit from it reside. The design and impact of intergovernmental grants, also a major focus of fiscal federalism, are not directly relevant to this chapter and are not discussed.

A final component of fiscal federalism is regulatory federalism. Regulatory federalism has the same goal as intergovernmental grants – enticing state/local action – but differs in that it provides a negative rather than a positive incentive for action. Recognition of intergovernmental grants emerged in the 1980s when the federal government evidenced concern over federal deficits and put in place rules requiring new programs to be funded with new taxes or cuts in existing programs. Given these hard choices, in many instances Congress augured for an approach which allowed them to “take credit” for solving a problem without breaking its budgetary rules for new spending by mandating states and often local governments to act. Kincaid (1990) dubbed this period as coercive federalism when the number of federal preemptions of state and local authority skyrocketed. While not a focus of this chapter, intergovernmental regulation is an important component of allocation of functions – one which both political parties have found valuable in meeting their desired goals.<sup>10</sup> In the past ten years, there has been some loosening of intergovernmental regulations, particularly in the form of Medicaid waivers and proposals for increased waiver flexibility in other social programs (Gais and Fossett 2005).

## Politics at last

The political role in who does what has been recognized long before the US Supreme Court threw up its hands in the *San Antonio* case. Indeed, the ambiguity of the US Constitution naturally leads to resolution through political means. But this role was often ignored by economists in spite of the fact that what is economically efficient may not be politically possible or sustainable.

Chubb (1985) was one the first political scientists to empirically build on the work of the fiscal federalism economists in functional allocation. He analyzed two federal grant programs that should have differed in their effects based on the economic predictions. In fact, he found the exact opposite of what economists predicted because the political factors affected the oversight and ultimately the overall spending. More specifically, Congress influenced the implementation of the two grant programs in two ways: (1) the more liberal the committee was, the more likely it was to provide program oversight, and (2) having congressional members on the oversight committees led to more program oversight and greater grant effects (more overall spending rather than substitution) in their home states. Chubb’s work led to a wealth of research on the political impact on

federal and state bureaucracies in the implementation process (see for example, Wood 1988, 1989; Hedge *et al.* 1991; and Volden 1999). Its impact on federalism literature on functional allocation was less evident.

Anton (1989) conceptualized governments as providers or producers of economic, juridical and symbolic benefits desired by coalitions. These coalitions along with resources available answer the “who does what” question every time it arises. Anton argues that it is not only important to understand what government does but also who benefits from government action and how (p. 231). Perhaps because of the flexibility of Anton’s notion, it has not been used extensively by scholars. But it is an important contribution because like Chubb, it highlights the political aspects of these decisions and reminds us that advocacy plays an important part in answering the “who does what” question. Anton reminds us that “(p)olitical disagreements over purpose are replaced by agreements on dollar sums, leaving recipients of the dollars relatively free to use grants for their own purposes...”(p. 98).

Paul Peterson (1995) returned to the Musgrave assignment of functions but added the importance of the political role in these choices by classifying theories of federalism into functional and legislative. Functional theory is prescriptive, calling for the national government to take on redistribution and states and local government developmental functions. Legislative theory explicitly recognizes the importance of politics. Under this approach, policies are not put in place because of a careful allocation of economic purpose but rather because politicians make choices in ways that maximize their own benefits. Peterson examined federal expenditures over 30 years and concluded that both types play a role. He concluded that legislative federalism is the primary cause for short-term fluctuations, especially through the federal grant-in-aid, but that legislative federalism also helps us understand why some elements of functional federalism have been so difficult to achieve – particularly redistribution. Members of Congress and state legislatures are reluctant to tax their constituents for the benefit of other, less-well off, residents, making redistribution difficult, if not impossible.

A key component of the political role is credit-claiming. Both national and state policy-makers want to take credit for “bringing home the bacon” for their constituents and for other policies supported by those constituents. Unlike allocation programs that provide services to these constituents, redistribution programs provide services to non-constituents and thus do not help at reelection time. Indeed, in recent years Kincaid (1990) argues that elected federal officials felt it was important to be directly responsive to constituent demands to “make policy in virtually any field” (p. 149). He continues, that when states and localities are slow or fail to comply with federal mandates, policy advocates and beneficiaries do not criticize Congress, but rather their own states and localities for failing to

respond or being uncooperative. Thus, federal officials get to take credit and shift blame.

Finally, another political scientist, John Donahue (1997), adds another possibility to the functional criteria – where the payoff from innovation exceeds the advantages of uniformity (p. 165). Donahue is not the first to highlight the notion of the value of states as laboratories of democracy. Certainly Rivlin, Anton, and Peterson also recognize the importance of interstate variation and President Nixon noted creativity as a factor in the reallocation of responsibilities. However Donahue squarely positions policy diffusion as a criterion – the greater the need for innovation (say for example, a “new” problem or solution), the greater the rationale for that function provided by the subnational government. This argument fits best when looking at individual policies, not broad areas of responsibility, but provides another useful component for discussion.

### **Putting it all together: who does what?**

The “what government does what” question has vexed scholars and politicians since the beginning of the country. There is agreement on a few national functions – i.e., national defense and monetary policy – and a few local functions – i.e., those services that reside solely within local boundaries (garbage collection, police and fire services). But even the latter issues can be affected by state and federal regulatory policies and incentive payments. Clearly Rufus Davis was correct that the federal principle is not meaningful or relevant because the decisions are made by politicians (at all levels) who want to take political “credit” regardless of the theory or science. Intergovernmental grants and intergovernmental regulation allow political credit-taking and position various levels of government to define policies and deliver programs. Other concerns play a role – for example the presence (or absence) of a large federal deficit or state fiscal difficulties. Finally, some researchers argue that criteria for functional assignment should be made on a case-by-case basis rather than broad categories.

But that does not mean that we throw up our hands and abandon a rational approach. What it does mean is that there needs to be some new thinking about the reality of the federal principle. Much of this new thinking has evolved over the past 25 years and can be summarized like this:

- Institutions matter too. The new institutionalism that became popular in political science in the 1980s has played out in the revitalization of states as capable administrative and political actors (see for example Rivlin 1992a; Bowman and Kearney 1986, 2002; Weissert and Weissert 2002). However, this recognition typically plays out only marginally in the broader discussion of which government should do what. Rivlin

brought the issue foursquare into the debate arguing that increased competence and responsiveness of state governments weakened the rationale for many federal programs.

- Recognition that political factors play an important role in the allocation of functions. While certainly this idea is not new, it is only in recent years that the recognition has taken a more important role in allocation (not simply as part of the economists' error term). Politicians – federal and state – seek credit for their activities and they do so, regardless of economic and rational arguments. The ACIR recognized this in its seminal study of the federal grant system – including why there was a “federal role” in such areas as fire protection in rural areas. In more recent years, the recognition has taken a more prominent role in formal modeling of federal and state actions.
- Recognition that context is important. One important element of context noted by Anton and other scholars is resources. For many decades, the national government had resources to invest in programs (unlike states which are often held back by constitutional restrictions for a balanced budget). With resources (and political desire), action seems assured – whether it is justified or not. But the opposite is also true. When the federal government has a seemingly overwhelming deficit and calls for additional defense spending and international aid, there may be more interest in shifting responsibilities for pesky programs to the states. This was certainly the case in the 1996 change in welfare from an entitlement to a block grant program, where deficit reduction figured prominently in the debates and eventual outcome.
- A closer look at the decision-calculus of decision-makers. Chubb argued for this “positive” approach in 1980. Helen Ingram in 1977 used the metaphor of a game in describing federal and state relationships, particularly in implementation. Hill and Weissert (1995) and a few others have similarly considered the rationales for decision-making (including political ones) in predictive models. Another important part of the rationale is states' expectations concerning future federal actions – and their read on how strongly the federal government supports/pushes their plan (thus how quickly/well states will respond).
- Revisit redistribution. Concerns over race to the bottom or states becoming welfare “magnets” have generally been overstated (see for example, Schram *et al.* 1998 and Berry *et al.* 2003). While politicians may choose to believe generous benefits will pull in welfare recipients from other states, little evidence exists that this “voting with their feet” occurs. Given the importance of this logic on the normative views that redistribution should be a national function, perhaps this longstanding standard should be revisited by scholars and practitioners alike.
- Revisit efficiency. While not an original part of the Musgrave schema, efficiency has lurked as an important component. But the question is

how. Does it promote higher level responsibilities where economies of scale exist and lowest level where they do not? Certainly many economists including the Ostroms argue for the lowest level for both efficiency and responsive arguments. Can this be included more systematically in discussions of what government does what?

- Incorporate regulatory federalism into schema. The negative incentive provided in regulatory federalism is a major tool used by federal officials in both redistributive and allocative functions. Its use is primarily related to the availability of federal funding than to criteria discussed here.
- One recent scholar has called for the possibility of innovation in the decision-calculus of who does what. Whether this is a “credible” criteria or not, it leads to an important point of change. Is it possible that we should be thinking of short-term allocations differently from more long-term allocations of responsibilities. Might not innovation be a recognition that in newer areas, where there is uncertainty and little consensus on the problem or solution, allocation can be made initially, with the expectation that it might later morph into something else and possibly engage another governmental level?

In summary, while the long history of failed or incomplete efforts at defining what governmental level can lead to discouragement and reaffirmation of Davis’ summary dismissal of half century ago, the recent advancement in thinking augers for a more promising approach, one that recognizes context and positive theory and one that can help predict and serve as the basis for later empirical work.

## **A promising approach**

What theoretical approach can best incorporate this thinking? My proposal would be an approach that recognizes the rational calculations and/or motivations of politicians at different levels of government – one that clearly incorporates both institutions and politics. Formal models allow academics to deal with the dynamic behavior of governments that can easily be ignored under a more normative allocation of who should do what. They can focus on strategic agents (federal and state) responding to an incentive environment. They provide a mathematical structure outlining the logical flow from assumption to result (Bednar 2000). For example, states may stall or shirk duties they do not support, knowing that there is a possibility that the Congress can change its mind and forsake or alter faulty policy initiatives (Hill and Weissert 1995). Qian and Weingast (1997) and Bednar (2006) examine the incentives political officials must have to abide by the rules of federalism including political parties, the courts, and the citizens themselves through the electoral process.

In recent years, formal models of federalism have proliferated, largely in comparative politics. Spawned by the international interest in federal systems, these theorists considered such issues as market-preserving federalism where subnational units can help the national unit keep its promises regarding repayment of debt and accountability for action which helps the country's economic growth (Qian and Weingast 1997); the role of risk sharing and moral hazard in federal systems (Persson and Tabellini 1996); the importance of commitment and institutional design to fiscal discipline in federal countries (Rodden 2006); and studies concerning the equilibrium size of units in a federation (Alesina and Spoloare 1997).

While these issues of federalism stability and impact are important, they have yet to help us define the roles of government. Volden (2005) provides a step in the right direction in understanding the political dimensions of credit-taking. He finds that the governmental level best able to supply particular goods and services tends to take the lead in their provision (for example, the federal government and national defense). However, both state and national politicians want to take credit for public spending and their joint provision leads to a relative oversupply of public goods and services, and thus to over-taxation. When there is substantial heterogeneity across the states, intergovernmental political competition produces more desirable outcomes than either strict national provision or strict state-level provision. Under joint provision, states will respond differently according to the causes of changes in national spending patterns and on state characteristics.

Kollman *et al.* (2000) look at the impact of the difficulty of the problem in determining which government is the best problem solver. They find that easy problems and extremely difficult ones can best be dealt with by the national unit. However, moderately difficult problems benefit from a search for policy solutions in parallel with information shared to reveal better solutions (innovation). Preferences of the subunits – particularly whether they are homogenous or heterogenous – were also modeled. Where subunits have heterogeneous preferences (thus reducing the importance of local ability to deal with those preferences), more centralization is best at solving problems.

Clearly, the use of formal modeling to answer the question at hand is in its very beginning stages. Nevertheless, using these tools to combine political and economic concerns (as did Volden) and to compare federalism across time and space as many international scholars are doing, are exciting new avenues to answer age-old questions. The metaphor of an intergovernmental “game” has been used for decades to help visualize and understand the dynamic intergovernmental system. Newer approaches can build on the game notion and how it defines the policy assignment process. Also important is empirical testing of the findings of the formal model. Agranoff (2001b) argues for a more “empirical

federalism" including field work on the degree of centralization and cooperation in place. Indeed, a number of scholars are building on such issues as the role of federalism in shaping market forms (see for example, Gibson 1997; Wibbels 2005).

## Conclusion

As Martha Derthick (2000: 24) once put it, "American federalism is a high protean form, long on change and confusion, short on fixed, generally accepted principles." Yet change and confusion have long been left out of our thinking about allocation of functions. We have often assumed that the prescription laid out by Musgrave and others was clear-cut and inviolate – even in the face of a history where it was largely ignored. More recent thinking about federalism generally has provided useful information to help us answer these questions. In short, we need to consider the context and politics as well as the economics of the question. We need to think about timing issues – is there a need for an innovative policy that might start out as a subnational problem and become a national concern later. Is the nature of the problem difficult or easy? Can we better integrate the choice of regulatory federalism as an option for policy-makers into our models?

We are also at the beginning of possible new approaches as well. Taking advantage of mathematical models – followed by empirical assessments – seems obvious and should be welcomed by federalism scholars. Normative theory has largely prevailed in this area. A more positive approach – along with careful testing, using international situations – seems extremely beneficial. An academic confederation of political scientists and economists typically more focused on their own narrow areas of American federalism, international relations, or formal modeling seems the best of all worlds and may advance a better answer to the who does what question posed and poorly answered for generations. Davis may be partly right – that a simple federal principle may be impossible to forge. But he may be wrong to disparage trying to develop science or theory. Fifty years later we can develop a more sophisticated understanding and theory, one that applies across all federal institutions.

The US approach to solving the assignment problem is not a success story in the sense that there is no right answer to provide for other federal systems. However, in another way, the US experience is telling and informative. It illustrates that there is no easy fix, no secret handshake or magic constitutional language that can serve to easily delineate responsibilities across levels of governments. Like federalism itself, the assignment of functions is dynamic, responsive and constrained by institutions, personalities, and events that themselves change and respond to societal demands.



## Notes

- 1 Thomas Jefferson. 1903–04. *The Writings of Thomas Jefferson – Memorial Edition*.
- 2 The Clinton Administration did try to implement at least part of Rivlin's vision – a national health insurance program. However, for a variety of reasons, the program never made it beyond a 1,342 word White House proposal (see for example, Weissert and Weissert 2002).
- 3 See for example, Nivola (2005) and Dinan and Krane (2006) for concerns and examples of recent federal incursions into areas of state policy jurisdiction.
- 4 See for example, *New York v. United States* 505 US 144 (1992) and *United States v. Lopez* 514 US 549 (1995).
- 5 PL 86–380. Summarized in ACIR 1974. This description of the Commission's charge was included in every ACIR publication.
- 6 The recommendation also called for states and local government to continue to *administer* public assistance program.
- 7 President Richard Nixon (1968–74) had no state experience but did propose a far-reaching New Federalism. In addition to general sharing program for states and localities (which passed), he proposed an ambitious welfare program where the federal government would guarantee a minimum national payment plus food stamps. Only one part of the program – a new federal program for the elderly and disabled – became law (Conlan 1998).
- 8 From President Reagan's 1981 State of the Union address, cited in Oates (1982: 473).
- 9 Nathan *et al.* (2003) note that Reagan's swap was the second proposed in the second half of the 20<sup>th</sup> century. In 1960 President Eisenhower's Federal-State Action Committee proposed a federalism swap, eliminating specific federal grants-in-aid to the states in exchange for turning over an amount of federal revenue equal to covering those grants. A proposal turning over telephone excise revenues to states in return for elimination of federal grants in vocational education and water pollution control was sent to Congress where it died.
- 10 See Conlan (1998) for a detailed explanation of how President Reagan urged regulatory relief but in fact added regulatory burdens on states and localities when they helped achieve the administration's other economic or ideological goals.

# 9

## Efficient and Equitable Service Delivery in a Federal System

*Daphne A. Kenyon*

Just because government has the responsibility for providing a service does not mean it necessarily has to deliver that service (Musgrave and Musgrave 1989: 9).<sup>1</sup> This is the fundamental insight upon which this chapter is based. Consider the case of elementary education. Local governments in the US typically operate public schools in order to carry out their responsibility for providing elementary education. However, there are several service-delivery alternatives: local governments can: (1) provide vouchers so that citizens can purchase schooling from private schools; (2) contract with private companies to operate schools; or (3) regulate parents who home school their children.

The focus of this chapter is delivery alternatives for services that should be provided by state (regional) or local governments. The problem of which type of government is responsible for providing particular government services is discussed by Carol Weissert (Chapter 8). Service-delivery alternatives have two major dimensions: “how” and “who.” The “how” describes the mechanism for service-delivery, such as vouchers or contracting out. The “who” describes the type of entity delivering a particular service. For example, education services can be delivered by government, private for-profit, or private non-profit entities.

Because federal governments exist to serve their citizens, service-delivery alternatives are an important federalism issue. However, service-delivery has not been traditionally seen as a critical element that distinguishes a federal government from a unitary one. Indeed, one of the service-delivery alternatives most often used by state and local governments in the United States, contracting out, is often used in unitary governments as well.

However, a philosophical stance in favor of considering service-delivery alternatives is consistent with, and can be considered an extension of, a particular theory of federalism – competitive federalism. Competitive federalism is a fairly recent theory of federalism that has been explored by both economists and political scientists. It emphasizes choice among alternatives, the importance of limiting government

power, and government efficiency, all of which can be promoted by judicious use of service-delivery alternatives, as this chapter will illustrate (Dye 1990). To some extent, competitive federalism is a reaction to problems with cooperative federalism, the paradigm that has been the dominant theory of American federalism since the New Deal (Kenyon and Kincaid 1991: 7–10).

This chapter is organized as follows. The first section addresses alternative mechanisms for service-delivery (the “how”). Following an overview of alternatives, the experience of US state and local governments with these alternatives is reviewed, and a case study of K-12 education in the US is presented. The second section provides an overview of the various entities that can deliver a particular question (the “who”) as well as a case study of health care. A discussion of the implications of service-delivery alternatives for achieving the goals of efficiency and equity follows. The last major section considers the applicability of the US experience to federal countries in Europe.

## **Alternative service-delivery arrangements**

In the following review of alternative service-delivery arrangements two themes stand out. There are potential benefits to citizens from moving from a non-competitive to a competitive structure for delivering government services. However, these potential benefits are not always realized.

### **Contracting out or outsourcing**

Because of the extensive use of contracting out or outsourcing by state and local governments in the US, this service-delivery alternative will receive the most attention.<sup>2</sup> The following paragraphs will discuss the potential benefits and pitfalls of contracting out, and summarize lessons governments have learned about this service-delivery alternative.<sup>3</sup>

The theory behind contracting is that a government agency can contract out some part of its duties that does not compromise its core mission in order to obtain cost savings. The private (for-profit or non-profit) entity that the government agency contracts with can potentially provide superior performance at lower cost because it specializes in that service. For example, the National Hospital of Denmark contracted with a private firm to provide cleaning services. Cleaning services are not part of the hospital’s core function and contracting out for these services should not compromise the hospital’s core function. In addition, Denmark apparently has a very competitive private market in building cleaning services. This example of contracting out was successful in that the National Hospital was able to realize substantial savings without compromising service quality (Jensen 1997).

There are several potential pitfalls, however. It is possible to merely substitute a public monopoly for a private one if there is only one potential private supplier. An example is contracting out for social services in New York State. One local government engaging in contracting found that only one certified residential domestic violence shelter existed (Van Slyke 2003: 303). A further difficulty in outsourcing social service functions is that the output is difficult to clearly define and measure. Because monitoring the contract is important, contracting is less effective if the private firm's output is inherently difficult to monitor.

Another difficulty is that contracting can make it more difficult for a government agency to respond to emergencies; vendor instability can also be a problem. Both of these potential difficulties can be illustrated by the case of public health laboratory services. Although private labs can capably run routine, high-volume tests, the public needs the capability for doing obscure tests in the face of incipient epidemics. The public interest would also not be served if a private lab that the government depended on went out of business at a critical time (Avery 2000).

Welfare reform in the United States (the change from Aid to Families with Dependent Children to Temporary Assistance to Needy Families) prompted state and local governments to outsource more employment and training functions to private entities. Mississippi's story is a cautionary tale for those who think that contracting out to private entities is an easy choice. Contracting was rushed and haphazard. Defining goals, aligning incentives of the various providers, and communication all presented substantial problems. After 17 months of these difficulties, employment and training functions were restructured so that the role of contracting out to private entities was substantially reduced (Breux *et al.* 2000).

There are a number of generally applicable lessons for government contracting:

- When setting up contract bidding or negotiations, it is important to make valid comparisons between public and private options. All costs, including overhead and capital costs, should be included in the comparison. In addition, obtaining the best value, not simply the lowest cost, should be the objective.
- Where possible, it is best to specify the contract in terms of outputs instead of inputs. This allows the private firm leeway to employ innovative techniques or technologies in achieving the end result. These innovations may lead to important cost savings.
- The contracting process should be set up with the aim of creating or maintaining a competitive market. For example, a competitive bidding process is better than a sole source bid.

- Staff issues can be critical and should be taken into account. If public employee unions adamantly oppose contracting out, the contracting process may be much less successful.
- The public agency must monitor the performance of the private firm receiving the contract.
- The public agency must invest in the skills necessary to negotiate contracts and to monitor the private firm's performance.

## **Competitive sourcing**

Competitive sourcing involves a competition between the private and public sector to see which can provide the service at higher quality and lower cost. After the competition, either the public or private sector may produce the service. An example of such a competition is road work repair in Indianapolis under Mayor Stephen Goldsmith, an enthusiastic supporter of privatization (This example is from Gansler 2003: 18–19). Rather than deciding to contract pot hole filling to a private company, Goldsmith set up a competition to decide whether a private company or the city's public works department could do the job more cost effectively. The public works department submitted a bid that was 25 percent lower than the current cost and won the contract. According to Gansler (2003), only the threat of competition removed some of the slack in the Indianapolis public works department and improved efficiency.

Competitive sourcing is better than contracting/outsourcing because there is an additional alternative. Instead of allowing only private firms to compete for the contract, public agencies can compete as well. On the other hand, setting up the competition may be somewhat difficult. The same employees who are the most knowledgeable judges for the competition become part of the competition. Another advantage of competitive sourcing is that employee layoffs can be prevented.

## **Franchising**

In franchising, the government gives a firm or firms the right to provide services to a group of citizens for a fee. Examples are local governments that give cable companies exclusive franchises or state governments that award electric power companies exclusive franchises over certain territories. Typically the government retains some regulatory control over the franchise.

An advantage of giving a franchise to a private firm is that the government need not develop the in-house expertise to provide the good or service. If the government retains the expertise to monitor the firm's performance, then the good or service can meet consumer demands at a reasonable cost. Problems arise when the government does not properly

monitor the franchisee or when it is assumed that the franchisee can have its exclusive position indefinitely. When there is insufficient oversight and competitive pressures are absent, the behavior of the franchisee can easily become like that of any inefficient, unresponsive monopoly.

## Grants/subsidies

Grants are payments to a private firm to induce that firm to supply more of a particular good or service. For example, a city may make a grant to a museum to allow it to stay open more hours and provide a cultural option for city residents. Such a grant may be preferred to having the city own and operate the museum when operational autonomy is likely to be more efficient. For example, the museum would not have to follow the same labor rules as other city departments and would have more opportunity to embrace innovations without needing approval from a larger bureaucracy.

## Vouchers

Vouchers are subsidies provided to individuals. Vouchers are typically capped at some monetary total, and individuals face restrictions regarding what they are allowed to use the funds for.<sup>4</sup> In the United States, vouchers are most commonly used by the federal government and least commonly used by local governments. Vouchers are used to provide food, higher education, primary and secondary education, housing, employment and training, child care, and medical insurance.

Vouchers promote choice by individuals, who generally favor having more choices rather than fewer choices. Vouchers can promote competition among potential suppliers and may induce new entrants into the market. In the best of all worlds, the competitive market that vouchers promote can improve efficiency in the part of the market that is not directly impacted by vouchers. Conservatives may like vouchers because of an additional feature:

Traditional government programs create two types of interest groups that may tend to work against future reform or amendment: the beneficiaries of the program and the public employees who serve them. Vouchers may limit the role of the second category of interest groups if the size of the bureaucracy can be kept smaller (Steuerle 2000: 33).

On the other hand, vouchers do not work in all markets. For example, education vouchers work better in an urban setting where there are many schools to choose from than in a rural setting in which students may have no choice of schools. In addition, the efficacy of vouchers depends on the capability of the consumer to evaluate his or her choices. Where information

and mobility are imperfect, vouchers are less effective. In addition, vouchers may induce suppliers to raise their prices, thereby garnering some of the benefit that was intended to go to individuals.

### **Public-private partnership**

In public-private partnership, the public and private sectors share production and, sometimes, financing. An example is a toll road recently built in Virginia (Gansler 2003: 34–5). The state of Virginia did not have funds to build a road to give residents of Loudon County better access to Washington, DC so it entered into a novel relationship with the partnership Trip II. Trip II built Dulles Greenway, an extension to the state-owned Dulles Toll Road. It was financed, built and operated with private money, but will be returned to public ownership in 2036. Despite a difficult start, the private toll road is now financially solvent and well used.

Sometimes public-private partnerships allow a facility or service to be financed when the government cannot afford to pay for it. Such partnerships can also draw on the expertise of two sectors. On the other hand, accountability can easily become blurred. In addition, unlike an outsourcing arrangement, there is no clear avenue through which the arrangement can be made subject to competitive pressures or renegotiated.

Now that each service-delivery alternative has been briefly discussed, we will now turn to a review of service-delivery alternatives used by state and local governments in the US.

### **Service-delivery alternatives used by local governments in the US**

Local governments now commonly use certain service-delivery options. Table 9.1 presents examples of contracting, franchising, grants/subsidies and vouchers used by local governments in the US. By far the most common service alternative is contracting with private (for-profit or non-profit) entities.

Table 9.2 lists 45 services often provided by municipal governments in the US. The third column indicates the percent of such services provided through contracts with private firms. The five services most often provided through contracting are: vehicle towing and storage, operation of day care facilities, operation and management of hospitals, operation of homeless shelters, and commercial solid waste collection. The five services least often provided through contracting are: prisons or jails, operation of libraries, tax assessing, title records and plat map maintenance, and utility billing.

The last column in Table 9.2 shows the trend in municipal contracting from 1988 to 1997. It is interesting to note that in the case of some services, the trend is toward reduced contracting. Examples are: utility billing,

**Table 9.1** Alternative service delivery options for common municipal services

Institutional arrangement	Education	Police protection	Streets & highways	Parks & recreation	Hospitals	Housing	Refuse collection	Transportation
Contracts	City hires private firm to conduct vocational training program	City hires private guard service for gov't buildings	City hires private contractor to clean and plow city streets	City hires private firm to prune trees and mow grass	Country hospital hires firm for food service	Housing authority hires contractor for repairs and painting	City hires contractor to collect garbage	School board hires bus company for student transport
Franchises				Firm is authorized to operate city-owned golf course and charge fees			City authorizes private firm to collect garbage and charge residents	Government gives private firm exclusive right to operate bus or taxi service
Grants/ Subsidies	Private colleges get gov't grant for every student enrolled				Gov't grant to expand non-profit hospital	Grant to private firm to build and operate low-income housing	City charges user fee but subsidizes elderly and low-income households	Gov't subsidizes bus purchases for private bus firm
Vouchers	Tuition voucher for elementary school				Medicaid card permits holder to get medical care anywhere	Voucher enables low-income tenant to rent any acceptable, affordable unit		Transportation voucher for elderly and handicapped to use for taxis

Source: Savas 2000: 88–9.



**Table 9.2** Municipal use of contracts with private firms for selected services, 1988–97

Service category	Service	Percent contracted to private firms	Change in percentage points, 1988–97	
Public Works Transportation	Residential solid waste collection	49.0	13.0	
	Commercial solid waste collection	60.2	22.2	
	Solid waste disposal	40.8	15.8	
	Street repair	34.8	-1.2	
	Street/parking lot cleaning	20.2	5.0	
	Snow plowing/sanding	13.5	-1.5	
	Traffic sign/signal installation/maintenance	23.9	-3.1	
	Operation/maintenance of bus transit system	30.4	4.4	
	Operation/maintenance of paratransit system	38.0	8.0	
	Operation of airports	19.9	-10.1	
	Disposal of sludge	28.2	9.2	
	Disposal of hazardous materials	39.2	-4.8	
	Public utilities	Utility operation/management: electricity	42.5	31.5
		Utility operation/management: gas	60.0	48.0
Utility meter reading		18.2	11.2	
Utility billing		13.1	-18.9	
Public safety	Emergency medical service	23.2	5.2	
	Ambulance service	37.0	13.0	
	Vehicle towing and storage	82.2	2.2	
Health & human services	Operation of animal shelters	33.9	16.9	
	Operation of day care facilities	79.3	45.3	
	Child welfare programs	27.2	10.2	
	Programs for the elderly	33.8	14.8	
	Operation/management of hospitals	71.4	47.4	
	Public health programs	30.0	11.0	

**Table 9.2** Municipal use of contracts with private firms for selected services, 1988–97 – *continued*

Service category	Service	Percent contracted to private firms	Change in percentage points, 1988–97
	Drug and alcohol treatment programs	55.8	21.8
	Operation of mental health/mental retardation programs and facilities	44.8	9.8
	Prisons/jails	3.4	2.4
	Operation of homeless shelters	65.9	22.9
Parks & recreation	Operation/maintenance of recreation facilities	14.7	2.7
	Parks landscaping/maintenance	20.2	7.0
	Operation of convention centers/ auditoriums	22.5	11.5
Cultural and arts programs	Operation of cultural and arts programs	42.4	19.4
	Operation of libraries	5.7	4.7
	Operation of museums	44.8	36.8
Support functions	Buildings and grounds maintenance	27.9	0.9
	Building security	19.6	6.6
	Fleet management & maintenance – heavy equipment	34.6	-6.4
	Fleet management & maintenance – emergency vehicles	36.6	-4.4
	Fleet management & maintenance – other	33.9	-4.1
	Tax assessing	6.7	-3.3
	Data processing	15.4	-1.6
	Collection of delinquent taxes	15.3	1.3
	Title records/plat map maintenance	8.2	-5.8
	Legal services	53.3	-1.7

Source: Morley 1999: 39.

operation of airports, and disposal of hazardous materials. The five services in which contracting increased the most during that time period are operation and management of gas utilities, hospitals, day care facilities, museums, and electric utilities.

Local governments typically contract for different types of services with for-profit and non-profit firms. Non-profit firms are typically used when local governments contract for health and human services (e.g., animal shelters and homeless shelters) and cultural and arts programs (e.g., operation of museums). For-profit firms are typically used for public works (e.g., residential and commercial solid waste collection) and support services (e.g., fleet management and vehicle maintenance). However, there are some services that are equally likely to involve for-profit and non-profit firms. For example, local governments are just as likely to contract with for-profit firms as with non-profit firms for the operation and management of hospitals.

### Service-delivery alternatives used by state governments in the US

In state governments the most common service-delivery alternative is also contracting with private firms. But according to the latest state survey, service-delivery alternatives are used less often than by local governments. "Privatized" services account for less than 5 percent of agency services.<sup>5</sup>

Table 9.3 lists the most commonly "privatized" state services by agency. Transportation departments appear to make the most use of private sector service alternatives for such functions as highway designs,

**Table 9.3** States "privatizing" programs or services, 1997

Agency	Program or service	Number of states "privatizing"
Administration & General Services	Custodial services	23
	Architectural services	21
	Asbestos removal	20
	Building construction	19
Corrections	Medical services at institutions	24
	Health/dental care	23
	Alcohol/drug treatment	21
	Correctional facilities construction	16
Education	Test scoring	13
	Program evaluations	11
	Technical consulting	10
	Hearing officers/lawyers	8

**Table 9.3** States “privatizing” programs or services, 1997 – *continued*

Agency	Program or service	Number of states “privatizing”
Health	Family planning services	18
	AIDS programs	15
	Clinics	14
	Infant mortality reduction	14
Higher education	Vending services	9
	Food services	9
	Office equipment repair/ maintenance	9
	Collections agencies	8
Juvenile rehabilitations	Group homes	18
	Mental health treatment	15
	Clinic evaluations	13
	Institutional residential programs	13
Labor	Temporary clerical services	11
	Consultants/researchers/specialists	10
	Security services	10
	Computer services	9
Mental health & retardation	Community living support services	17
	Psychiatric services	16
	Developmentally disabled services	13
	Therapists (activity, speech, recreational, physical)	13
Natural resources & environmental protection	Professional development training	19
	Engineering services	18
	Temporary clerical services	16
Natural resources & environmental protection	Computer maintenance	15
Parks & recreation	Construction	19
	Restaurant services	16
	Marina management	13
	Golf courses	8
Public safety & state police	Towing services	12
	Uniform tailoring for new recruits	12
	Consultants/researchers/specialists	9
	Medical services	9
Social services	Child care	15
	Consultants/specialists	14
	Independent living support services	14
	Food stamp issuance	12

**Table 9.3** States "privatizing" programs or services, 1997 – *continued*

Agency	Program or service	Number of states "privatizing"
Transportation	Highway designs	32
	Road & bridge construction	29
	Highway maintenance	27
	Grass mowing	25
Treasury	Banking services	9
	Bond counsel	8
	Bond underwriters	6
	Computer maintenance	6

Source: Chi and Jasper 1998: 22–49.

**Table 9.4** Variations in state contracting out after welfare reform

Function/State	Public	Non-profit	For-profit
<b>Eligibility Determination</b>			
Florida	X		
Mississippi	X		
New York	X		
Washington	X		
Wisconsin	X	X	X
<b>Case Management</b>			
Florida	X	X	X
Mississippi	X	<sup>a</sup>	<sup>a</sup>
New York	X		
Washington	X		
Wisconsin	X	X	X
<b>Job Placement</b>			
Florida	X	X	X
Mississippi	X	<sup>a</sup>	<sup>a</sup>
New York	X	X	X
Washington	X	X	X
Wisconsin	X	X	X
<b>Transition Supports (Child Care, Food Stamps, Medicaid)</b>			
Florida	X		
Mississippi	X		
New York	X	X	X
Washington	X	X	X
Wisconsin	X	X	X

Source: Liebschutz 2000: 12.

<sup>a</sup> 1997 and 1998 only.

road and bridge construction, and highway maintenance. Many of the service-delivery alternatives involve inputs for the agency. For example, temporary clerical services in departments of labor commonly use private sector service alternatives. However, it is not uncommon for a state agency to use a private sector alternative to supply services to its clients. For example, juvenile rehabilitation agencies use the private sector to provide group homes, and social service agencies use the private sector to provide child care.

Use of the private sector for service-delivery alternatives increased significantly from 1993 to 1997, but remained relatively constant from 1998 to 2002. The most common reason for using these service-delivery alternatives was cost saving. Reported cost savings from privatization ranged from zero to 5 percent. Many respondents did not have good information about the size of the cost saving. The survey did not compile information regarding whether privatization options involved for-profit or non-profit firms.

A study of welfare reform in five states shows how much contracting out can vary by state, and can vary by type of function within a single department (Lieschutz 2000). Table 9.4 distinguishes among the following aspects of state responsibilities for TANF clients: eligibility determination, case management, job placement, and transition supports. As the table shows, of the five states, Wisconsin clearly did the most contracting out of TANF-related services. Among the different functions, job placement was most often contracted out to non-profit or for-profit firms; eligibility determination was least often contracted out.

### **Case study: elementary and secondary education**

Before examining service-delivery alternatives in US elementary and secondary education, some background on provision and financing may be helpful. In the US on average, state governments and school districts each bear about half the responsibility for financing elementary and secondary education, with the federal government contributing only a small share of the finances.<sup>6</sup> There are about 15,000 school districts in the US, many of which operate as independent local governments, but some of which function as departments of general-purpose local governments such as cities (US Census Bureau 2002: 146).

It is important to realize the diversity among the states in the structure of financing and provision of elementary and secondary education. In Hawaii, elementary and secondary education is completely financed by the state, whereas until a few years ago, the state contributed only 8 percent of total elementary and secondary education revenue in New Hampshire. The fragmentation of school districts, and thus the competitive structure of local education also vary tremendously across the

country. In Florida, school districts are operated as a part of county government, so there are 74 school districts in that state of 16 million persons, with an average of about 35,000 students per district. On the other hand, Vermont has a population less than one million and 360 school districts, with an average of 360 students per district (National Center for Education Statistics 2003–04).

The US has longstanding experience with two service-delivery alternatives for elementary and secondary education. School districts have substantial experience with contracting out, for example, contracting with private companies to provide bus service or school lunches. The existence of private schools is a *de facto* service-delivery alternative. Certain parents opt out of the public school system and send their children to non-publicly-funded private schools.<sup>7</sup> Today about 11 percent of US elementary and secondary students attend private schools, and most (79 percent) are religiously affiliated (Sawhill and Smith 2000: 270).

In recent years, three new service-delivery alternatives have generated an enormous amount of attention:

- **Charter schools** are independently managed public schools of choice that are free from many of the regulations imposed on traditional public schools. As of October 2005, nearly 3,600 charter schools operated in 41 states and the District of Columbia, serving over one million students, or approximately 2 percent of the country's elementary and secondary students (Center for Education Reform; National Center for Education Statistics).
- **Vouchers** provide parents with either public or private funds in order to pay tuition at a school of their choice. The state of Wisconsin has provided vouchers to low-income students in Milwaukee since the early 1990s, and there are several other voucher programs across the country. But school choice through vouchers is much more limited than through charter schools (Rubenstein and Picus 2003: 78; Alliance for School Choice).
- **Private educational management organizations (EMOs)** enter into contracts with school districts to manage entire schools. In 2004–05 Edison Schools, Inc., which is the largest EMO in the US, managed 103 public schools in 18 states and the District of Columbia and served about 65,000 students (RAND 2005: 1).

There is little good evidence regarding the benefits and costs of these service-delivery alternatives, in part because these alternatives are relatively new and research evidence is scant, and in part because the assessment of these alternatives has become mired in ideology and politics.

The following quotes assessing American experience with charter schools give some flavor of the widely ranging assessment of these options. The first is by analysts supportive of innovations in school choice:

For now, the surest conclusion we can reach is that, while charter schools are unquestionably a dynamic force for change in education and indisputably popular with those who know them best, the jury is still out regarding their effectiveness in boosting student achievement (Finn *et al.* 2000: 98–9).

The second is by strong critics of some forms of school choice:

Despite their uneven, and in some cases dismal, performance records, charter schools may eventually make a positive contribution to American education...we argue at present that the charter school movement remains a disorganized and wasteful experience, not an effective investment... (Good and Braden 2000: 177).

An efficiency issue that arises for both charter schools and vouchers is whether by inserting competition into the existing state education monopoly, charters and vouchers will induce schools to improve their performance (i.e., higher academic achievement at lower cost). Related issues are whether these mechanisms will promote educational innovation and provide a more diverse menu of educational experiences.

Proponents of the benefits of a competitive market typically assume that the consumer is well informed and that consumer choice can work to discipline the behavior of firms (in this case, schools). There is a question whether parents can effectively exercise choice in an environment in which there is no good measure of educational output. Even parents who are interested in their children's academic achievement might be swayed by the availability of sports and other extracurricular offerings. That is why the following conclusion of an international study of privatization in Canada and various countries in Asia and Europe is instructive:

The relative effectiveness of private schools depends on whether the schools are preparing students for a common set of curriculum-based external exit exams (CBEEEs)...Private schools are particularly responsive to the incentive effects of exit exams. They outperform public schools only in jurisdictions with CBEEE systems. In nations and provinces without diploma exams, students at independent private schools did not have higher math and science achievement than students in secular public schools. This suggests that if tax credits and vouchers are to be offered for private school attendance (or publicly funded charter schools are to be established), subsidized schools should be required to participate



in statewide assessment systems and require their students to take curriculum-based diploma exams (Bishop 2000: 327).

Another useful international study is the Fiske and Ladd (2000) study of educational reform in New Zealand begun in 1989. That country abolished its existing education bureaucracy and set up a system that contains many of the aspects of American charter schools: decentralized management, parental choice and competition among schools. An important difference is that the entire educational system was changed rather than adding a competitive element to a predominantly publicly funded and publicly run system. Fiske and Ladd found mixed results. On efficiency grounds, the new system appears to be a big improvement:

There is overall agreement that the new decentralized administrative structure is superior to the bureaucratic system that it replaced. The Tomorrow's Schools reforms succeeded in breaking up an educational bureaucracy that many people believed had become overly bureaucratic, inefficient, and out of touch with the needs of local communities (Fiske and Ladd 2000: 7).

But the equity assessment is much less sanguine. With the introduction of school choice, there resulted considerable sorting by ethnic group, and to a lesser degree, by socioeconomic status. Similar equity concerns arise in the American discussion of both charter schools and vouchers.

Sawhill and Smith (2000) note that voucher arrangements can be altered so that equity concerns can be addressed. They argue that one cannot issue a blanket judgment of all voucher programs, as the details are so important. For example, low-income children can be given preference in receiving vouchers, or can be given greater financial payments than high-income children. Voucher programs can also be targeted to urban locations where many low-income children are at risk of receiving an inadequate education. If one is worried about the quality of knowledge possessed by low-income households who are expected to act as informed consumers, then accountability standards can be imposed on schools qualified to receive voucher students, and parents can be provided with information as to how schools rank against national or state standards (Sawhill and Smith 2000: 269). All of these choices can turn a program that might provide a disproportionate advantage to high-income children and thereby raise equity concerns, into a program that provides substantial assistance to low-income children.

Educational management organizations are a less systemic change in the educational structure. The objective of private educational management organizations is to produce more efficient schools that improve student achievement while operating schools at lower costs than the government.

The experience with Edison Schools, the country's first private educational management company, founded in 1992, is instructive. The US General Accounting Office concluded that it could neither verify nor refute Edison Schools' claims of better academic performance of its students (Schemo 2002). RAND found that test score gains of Edison schools did not exceed those of comparison schools during the first three years of Edison management, but many Edison schools outperformed their comparison schools after four or five years (RAND 2005: 1).

It is now time to address the question: what considerations can help states or local governments decide whether to produce a service in-house or have either a for-profit or non-profit firm provide a particular service?

## **Alternative service providers**

### **Government agencies**

Government production is likely to be the preferred alternative when the governmental function is a sensitive one that would be difficult to monitor if done by a non-governmental entity. For example, in local government public works departments, inspections and code enforcement are nearly always the responsibility of government employees. Only rarely is this function contracted out to private or other governmental entities (Morley 1999: 35).

However, there are also reasons why government production falls short.<sup>8</sup> Government employees may be more interested in maximizing the size of their bureaucracies or avoiding risk than maximizing the efficiency of their agency's production. Politicians may interfere with productive efficiency by inserting other goals for agencies, such as increasing employment in certain geographic areas. Restrictions on bureaucratic behavior, sometimes in the interest of preventing corruption, can themselves increase costs. For example, procurement restrictions can make purchasing more cumbersome. Employee unions and civil service rules can make it difficult to fire under-performing employees or to attract the most qualified employees. Because budgeting is typically done on an annual or biannual basis, it can be difficult to plan for and finance large investment projects. For example, US airlines have been able to invest in expensive, but very productive, reservation systems at that same time that the Federal Aviation Administration has been stymied in its efforts to upgrade its air traffic control technology. These are all reasons that may make production by for-profit or non-profit firms more attractive.

### **Private for-profit firms**

Private for-profit firms are likely to be the preferred alternative when a particular service is highly dependent upon technology, is capital-intensive, or

benefits from economies of scale or scope. For example, state governments contract with private firms for computer services. Certain private for-profit firms may have the most up-to-date computer technology, and this is one way in which the public sector can take advantage of the private sector's technological advantage. As will be discussed below, for-profit firms have greater access to capital and tend to be larger than non-profit firms. Therefore, if the good or service involves cutting-edge technology, is capital-intensive or benefits from economies of scale or scope, it may be more advantageous for the state or local government to contract with a for-profit firm than a non-profit firm.

In some cases, when a state or local government considers contracting with a for-profit firm, this indicates that government provision is not really necessary. For example, some years ago the state of New Hampshire considered outsourcing part of its state liquor store monopoly. (The State of New Hampshire owns and operates liquor stores under a state-maintained monopoly.) However, liquor is an example of a good that economists classify as a private good, and there is no case, other than a political one, for the state to own and operate liquor stores (Rosen 2005: 56).

### **Non-profit firms**

The study of non-profit firms is a more recent field than the study of for-profit firms or governments. There is no single theory of non-profit behavior that has achieved dominance. The brief sketch below follows the work of Henry Hansmann, who emphasizes the role of trust in the relationship between non-profits and their customers (Hansmann 1980).

Non-profit firms are subject to two important constraints under US law, which affects their behavior. The first is the "non-distribution constraint" which prohibits a non-profit from distributing profits to the individuals who control it. As a consequence of this constraint, non-profits cannot issue stock, and therefore have less access to capital than do for-profit firms. This may be one of the reasons that the typical non-profit is so small (Salamon 2002; Goodspeed and Kenyon 1993). There is also a "reasonable compensation" constraint on management salary and expenses, which places limits on managerial compensation. The non-distribution and reasonable compensation constraints make it more difficult for a non-profit organization to divert funds away from an organization's mission. For this reason, non-profits often excel in sectors where trust is important, such as the health care field.

There are at least four alternative theories of non-profit behavior which will be very briefly summarized: (1) the "heterogeneity theory" argues that non-profits arise in order to meet unsatisfied demand for services in situations of heterogeneous preferences; (2) the "supply-side theory" emphasizes the role of ideologists and entrepreneurs in founding and operating non-profits; (3) the "interdependence theory" emphasizes the complementary relationship between non-profits and governments, and (4) the "social

origins theory” argues that relationships among social classes, party politics, interest groups, and government regulations can explain the role of the non-profit sector (Anheier and Mertens 2003: 280–1).

Now that the general characteristics of the alternative sectors have been outlined, one case study will be presented. The sector chosen is one containing government, for-profit, and non-profit providers. It is also a sector that has seen tremendous challenges and changes in recent years.

### **Case study: health care industry**

The following Table 9.5 presents ownership patterns and recent changes in ownership patterns for sub-sectors of the health care industry. It reports the percentage ownership by for-profit, non-profit, and government entities. The table is divided into sectors in which for-profits have expanded significantly, for-profits have declined and non-profits have gained market share, and non-profit share has been stable.

The first section of the table above includes those health care sectors in which the market share of for-profit firms has expanded considerably in recent years. According to Gray and Schlesinger (2002), the performance of these sectors supports the view that, “for-profit growth is a result of the inability or failure of nonprofit providers (as a result of either restricted access to capital or weak entrepreneurial incentives) to respond quickly to substantial increases in demand for their services” (Gray and Schlesinger 2002: 83).

As one example, consider the case of dialysis centers. As of 1970, less than 5 percent of dialysis was provided through for-profit entities. The critical change was the inclusion of end-state renal disease treatment under Medicare in 1972. After that, the number of dialysis patients whose treatment was paid for by the federal government surged, and the for-profit share of dialysis centers grew rapidly, reaching 68 percent by the mid-1990s (Gray and Schlesinger 2002: 84).

There are two important downsides to the dynamism of the for-profit sector. First, if the opportunity to earn profits in a particular sector falls, for-profit provision may fall quite rapidly. Second, “the aggressive pursuit of profit provides incentives within companies that may induce illegal or unethical behavior.” As an example, Gray and Schlesinger (2002) cite the case of psychiatric hospitals. They state that in the 1990s all leading for-profit companies operating psychiatric hospitals were subject to “widespread fraud investigations followed by successful prosecutions and settlements.” The charges included, “unnecessary admissions, hospital stays involving high charges and little treatment until hospital benefits were used up, and kickbacks to referring physicians.”

To the extent that trust is important, then, the non-profit sector has an advantage over the for-profit sector. In the health care sector, the patient often is at a disadvantage because of the highly technical nature of health data and the difficulty of being an empowered consumer when one is ill.

**Table 9.5** Ownership patterns and trends, by health care domain

Domain	Percent ownership	
	Mid-1980s	Late 1990s
<b>Domains of for-profit expansion</b>		
Dialysis centers		
For-profit	42	68
Non-profit	58	32
Rehabilitation hospitals		
For-profit	15	58
Non-profit	70	35
Government	15	7
Home health agencies		
For-profit	36	67
Non-profit	64	33
Health maintenance organizations		
For-profit	35	74
Non-profit	65	26
Outpatient mental health clinics		
For-profit	6	18
Non-profit	64	57
Government	31	24
Hospice programs		
For-profit	13	28
Non-profit	82	65
Government	5	7
<b>Domains of non-profit resurgence or for-profit decline</b>		
Nursing homes		
For-profit	75	65
Non-profit	20	28
Government	5	7
Private psychiatric hospitals		
For-profit	76	73
Non-profit	24	27
<b>Domains of non-profit stability</b>		
Multi-service mental health organizations		
For-profit	1	8
Non-profit	67	68
Government	30	24
Acute care hospitals		
For-profit	14	16
Non-profit	58	59
Government	28	25

Source: Gray and Schlesinger 2002: 68–9.

For this reason, the non-profit sector can outperform the for-profit sector, and has either gained market share or maintained market share in a number of sub-sectors, such as the acute care hospital sector.

## **Trade-off between equity and efficiency**

Economists usually evaluate policy alternatives according to the dual objectives of equity and efficiency. The themes of equity and efficiency have been woven into the above discussion of service-delivery alternatives. For the most part, efficiency has been narrowly defined as production at the lowest cost, which economists call “productive efficiency.” A strong finding of the discussion is that potential efficiency does not ensure realization of efficiency. For example, contracting out may help government achieve cost savings, but unless it is carried out carefully, these savings may not be realized.

Not all service-delivery alternatives appear to have a strong equity component. For example, the decision about whether to explore alternatives to government service-delivery for hospital cleaning services or road-building do not appear to have important equity dimensions. In other contexts, equity considerations are both important and wide-ranging. For example, the use of school vouchers raises the concern that parents with lesser access to information may realize fewer benefits from the program than those who are better informed. Another example of an equity issue is the experience of for-profit companies operating psychiatric hospitals which led to some unscrupulous companies profiting at the expense of the general taxpayer.

In situations in which both equity and efficiency dimensions are important, sometimes efficiency gains can be realized at the expense of equity losses. For example, New Zealand’s experience with charter schools led to a more efficient system of schools, but with an undesirable increase in sorting by ethnic group. Fortunately, sometimes service-delivery alternatives can be tailored in order to achieve the efficiency gains without bearing the equity losses. The proposal for targeting voucher programs to low-income children is a promising example of a service-delivery modification that aims for efficiency gains without equity losses.

## **Application to other federal countries**

Thus far, this chapter has concentrated on examining the various dimensions of alternatives for service-delivery in the US federal system. This section will turn to considering the broader lessons for federal and quasi-federal countries in Europe. First, two critical differences between Europe and the US will be addressed; then the chapter will speculate regarding lessons for Europe from the US experience.

## **Privatization in the US vs. Europe**

Much of the literature that analyzes service-delivery alternatives discusses the concept of privatization. Yet privatization is defined in different ways,

and typically means one thing in the US context and another in the European context. In the European context privatization usually means selling public assets to private entities so that provision of the good or service is moved from the public to the private sector (See for example, *Economist* 2002). The government no longer has the responsibility for overseeing production of the good or service in question, except to the extent that government is generally responsible for regulation of health, safety, and market competition in the private sector. Privatization is typically the best policy when the government has been providing a good or service that is a private good that should not have been provided publicly in the first place.

In the US, the term “privatization” is often used in a much broader sense. For example, a recent Council of State Governments report defines privatization as “the use of the private sector in government management and delivery of public services” (Chi and Jasper 1998: 3). According to that expansive definition, contracting out and all of the alternative service-delivery arrangements discussed in this chapter would be included under the heading of privatization.

The general concept of privatization became popular in both Europe and the US in the early 1980s. In Europe, Margaret Thatcher led the way and in the US Ronald Reagan stimulated much of the public interest in privatization. The disparate meanings of privatization probably had much to do with the continents’ respective starting points *vis-à-vis* the division between public and private sectors as Table 9.6 illustrates.

Given the situation in the late 1970s, when the post office was the only business with 100 percent government ownership in the US and several European countries had 75 percent or greater government ownership of telecommunications, electricity, gas, coal, railways, airlines, and

**Table 9.6** Approximate percentage state ownership of business, late 1970s

Business	Britain	France	West Germany	Italy	United States
Post office	100	100	100	100	100
Telecommunications	100	100	100	100	0
Electricity	100	100	75	75	25
Gas	100	100	50	100	0
Oil Production	25	n.a.	25	n.a.	0
Coal	100	100	50	n.a.	0
Railways	100	100	100	100	25
Airlines	75	75	100	100	0
Automobiles	50	50	25	25	0
Steel	75	75	0	75	0
Shipbuilding	100	0	25	75	0

Source: Galambos 2000: 275.

steel, the differing discussions of privatization begin to make sense. For example, an article about privatization in Europe mentioned the possibility of governments selling their assets in telecommunications, airports, railways, electric utilities and oil companies (*Economist* 2002). In contrast, an article about privatization initiatives put forth by state governments in the US mentioned contracting with private firms to provide human resource services and printing services, and possible public-private partnerships for providing education and transportation (Chi *et al.* 2003: 1).

### **Non-profits in the US vs. Europe**

Another important difference between Europe and the US is the role of non-profits. The US has traditionally had a more limited role for government and a greater emphasis on individualism than Europe. Thus, one US synonym for the non-profit sector is the “independent sector.” Europe has had a greater welfare system or safety net, and the non-profit sector has had less autonomy. As an indication of its different role in Europe the non-profit sector is sometimes called the “social economy.”

History has also played a major role in the differences in the non-profit sector in Europe compared to the US. As two examples, Borzaga and Santuari mention, “from the end of the eighteenth century, when the French Revolution broke out in Europe, except for England, a kind of suspicion and aversion to charities began to grow” and “Fascism and Nazism, which brought with them a deep fight against any expression of civil society and forms of local autonomy” (Borzaga and Santuari 2003: 35). As a result of this very different history, European governments have placed much stronger direct restrictions on non-profits. The role of indirect constraints, such as the non-distribution constraint, is much smaller.

### **Contracting out is important for both the US and Europe**

Although there are major differences between Europe and the US with respect to the role of government, the forms of privatization and the role of non-profits, contracting out from government to non-profits is important for each. In the US an increasingly conservative electorate has supported service-delivery alternatives that can be described as privatization. In Europe, a critical reexamination of the role of the welfare state has led to “[d]ecentralization, privatization and separation of funding and provision of services...” (Borzaga and Santuari 2003: 45).

The consideration of service-delivery alternatives in the US has placed a greater emphasis on low-cost production or efficiency than in Europe. Thus European countries might learn from the US about such options as



competitive sourcing or about the competitive theory that underlies many of the service-delivery alternatives in the US. The US on the other hand, could learn from Europe about a different model of alternative service-delivery – one that puts a greater emphasis on equity, and considerations such as the creation of social capital.

## Conclusion

This chapter has attempted to gather together information on service-delivery alternatives used by state and local governments in the United States that can be useful for other federal or quasi-federal countries, particularly those in Europe.

In addition to the choice of producer (government, private for-profit, or private non-profit – the “who”), there is a choice among various production arrangements – the “how”. These arrangements include the following:

- **Contracting/outsourcing** involves governmental contracting with private entities (either for-profit or non-profit) for performance of certain services.
- **Competitive sourcing** is an arrangement whereby a government entity competes with the private sector to see which can do a better job of producing a particular service. After the competition, the service may be produced either by the private or public sector.
- **Franchising** gives a firm or firms the right to provide services to a group of citizens. The government awarding the franchise may set service standards, monitor complaints and impose price controls.
- **Grants/subsidies** from a government to a private (for-profit or non-profit) firm encourage the firm to provide services that otherwise may be provided directly by government.
- **Vouchers** are coupons with a monetary value that government distributes directly to citizens so they may purchase services from eligible public, non-profit or for-profit private firms.
- **Public-private partnership** is an arrangement whereby production is shared by the public and private sectors.

Several themes run through the chapter. One is that considering alternatives for service-delivery is often motivated by an interest in improving efficiency, or cutting costs. In order to improve efficiency, it is not simply necessary to adopt a different service-delivery mechanism – a competitive structure for service-delivery must be implemented. Furthermore, it is not always easy to realize the efficiency potential of a service-delivery alternative. Sometimes service-delivery alternatives that have the potential for improving efficiency also raise equity concerns. Another theme is that there is no simple approach to service-delivery

that will fit all governments or all services. The differences between the US and Europe in the role of government relative to the private sector and differing histories also caution against a simplistic application of experiences from one country to another. At the same time, it is useful to know that there is a wide menu of service-delivery alternatives to choose from. Certainly learning about other governments' experience with these alternatives can help one to avoid pitfalls and increase the likelihood of making successful choices on service-delivery alternatives.

## Notes

- 1 Many thanks to Bethany Paquin for her able research and editing assistance.
- 2 According to Gansler (2003: 13), contracting generally refers to goods or services that are purchased from a private entity for relatively short periods of time, but outsourcing refers to longer agreements with private entities (i.e., at least seven to ten years).
- 3 Although many sources were consulted, the most helpful guide was Organization for Economic Co-operation and Development 1997.
- 4 Most of the information in this section is derived from Steuerle 2000.
- 5 The Council of State Governments uses the term "privatize" to encompass all of the service-delivery alternatives considered in this chapter. Most of the information in this section is derived from Chi *et al.* 2003 or Chi and Jasper 1998.
- 6 In 1992, the percentage contribution to public schools was 46.4 for state government, 47.0 for local government and 6.6 percent for the federal government (Fisher 1996b: 498).
- 7 The United States does not have publicly funded and regulated schools run by religious organizations. This type of school is common in Canada and Europe (Bishop 2000: 325).
- 8 Much of this section relies on Stiglitz 2000: 204–8.

# 10

## Intergovernmental Policy Management: Cooperative Practices in Federal Systems

*Robert Agranoff*

Federalism in its broadest sense involves multiple levels of government that necessarily interact. As the late Daniel J. Elazar (1996: 419) concluded, "It is not that states are disappearing, it is that the state system is acquiring a new dimension, one that began as a supplement and is now coming to overlay (and, at least in some respects, to supersede) the system that prevailed in the modern epoch. That overlay is a network of agreements that are not only militarily and economically binding for *de facto* reasons but are also becoming constitutionally binding, *de jure*." That is why there are so many diversified experiments with various forms of federalism and federal arrangements: to face the complexity in 21<sup>st</sup>-century governing. Indeed, within various countries some combination of ethnic/territorial governing, regional economic development, local democracy/citizen government, supranationalism (e.g., European integration), global concerns and globalization, and cross organizational networking are converging to ensure this variety. That is why the question "Which Federalism?" becomes relevant. Different cultural, political, and economic forces lead to the variety of federal situations in countries like Italy, Spain, Germany, Belgium, Canada and the United States, to name a few. Underlying all of these emergent federal arrangements, however, is the need to *manage the interactions* within the network of agreements that necessarily emerge throughout various federal systems. That is the focus of this chapter. Specifically, how collaborative management operates between levels in various countries which, as will be demonstrated, have become operational matrices rather than hierarchical pyramids (Agranoff 2001b).

The 20<sup>th</sup> century proved to be one where governments at all levels increased their powers and responsibilities. Democratization brought on worker's parties, which led to welfare states, which in turn created widespread central programming (Ashford 1986; Furniss and Tilton 1979). The quest for equality of opportunity and the benefits of government led to expanding definitions of social needs, making government more interventionist. It also brought on increased concern for the rights of citizens. As a

result, the welfare state initially led to greater bureaucratization, centralization and managerialism in the public sector (Ashford 1986; Wilson 1975). Over the century, however, programs were increasingly put in the hands of subnational governments, as co-policy-makers or as implementers, and in many situations both. In the early 21<sup>st</sup> century, a redefined multi-level post-welfare state exists, that includes global influences, with greater movement toward decentralization and devolution, along with the development of new ways to deliver public services, including those involving citizens, non-governmental organizations and the private sector (Loughlin 2000; Webb 2006). Throughout these transformative processes, managing policies through cooperative intergovernmental processes has become a continuing concern within federalism of all types.

When governments are conceptualized by what they do rather than their formal constitutional processes one immediately thinks of an intergovernmental rather than a hierarchical model (Rose 1985). Analytically the operating governance concept is intergovernmental relations (IGR), administratively it entails intergovernmental management (IGM). Discernable patterns among regularized program contacts through multiple decision structures within multi-organizational arrangements constitute the core of IGR (Ostrom 1987). IGR involves a variety of types of public officials (courts, legislators, executives) involving the interactions of actors across boundaries surrounding policy formulation, implementation and evaluation (Wright 1988). Within these patterns are the activities of IGM, which Wright and Krane (1999: 1162) define as “the process of solving intergovernmental problems under conditions of high uncertainty and complexity through the creation and use of governmental and non-governmental networks.” As an action-oriented intergovernmental process, IGM involves transacting the routines of program through making legal-jurisdictional, political, technical and task or project-based adjustments to fit policies into real situations (Agranoff 1986; Agranoff and McGuire 2003). In federal countries and those with federal features, IGR/IGM is quite extensive and involved, in as much as multiple, independent jurisdictions are highly interdependent.

As governmental systems that both programmatically and constitutionally divide rule (Elazar 1987), federal jurisdictions enjoy measures of autonomy that are respected and exercised (Agranoff 2003c), and are different from those that are devolved in non-federated systems (Zariski and Rousseau 1987), where subnational governments are “subordinate” units. Constituent units in federal countries enjoy considerable degrees of independence or jurisdictional autonomy from their central governments. Often their local governments enjoy further measures of autonomy, if not legally then by the weight of historical and political tradition. This means that considerable effort is expended and mechanisms need to be developed to ensure cooperation and consultation among levels.

This paper expands on the concept of intergovernmental policy management to explore various means of cooperative intergovernmental interaction and consultation in federal systems. It explores the means that help make policy work in multi-tiered systems. As such, it seeks to identify mechanisms and to explore common patterns of intergovernmental cooperation. Initially, how the opening up of the welfare state led to multi-tiered government is explored. That is followed by discussion of the importance of place and subnational autonomy and how it differs from the prefectural or administrative tradition based on prior authorization. Then the case for collaborative policy management within federal systems is taken up. This is followed by identification of the major approaches to IGR, including executive federalism, joint policy-making and horizontal relationships, which are most typical within federal countries. The chapter then turns to identification of some of the major approaches to IGM: managerial practices, strategic tools, combining programs and managing for “place,” and horizontal networks at the local level. This examination of “macro” IGR and “micro” IGM practices will help to define the less visible pillars of government, the hidden but real policy systems between governments (Olsen 2006). Today’s federal systems involve simply too many programs and too many governments to be isolated in “water tight” compartments. Rather, they are intergovernmentalized within federal matrices.

### **The welfare state’s “open compartments”**

There is no doubt that the 20<sup>th</sup> century not only ushered in the welfare state but it gave rise to the intergovernmental model (Flora and Heidenheimer 1981). While hardly a new practice (Elazar 1962), the rise of numerous programs triggered attention to cooperative processes across governments. Ashford (1988) explains that most national social policies emerged because of national suspicion of local commitment and thus national governments centralized policy for over a century. In effect, programs were “parachuted” into local communities by central governments, and in federal systems usually through intermediate administrative landings in constituent unit governments. However, since the 1950s, “New social issues such as drug addiction, child abuse, single parentage and the mentally handicapped were not easily organized at the national level, nor were such needs evenly distributed. As a result, the advance of the welfare state was accompanied by important intergovernmental adjustments” (p. 19).

The most basic of such adjustments involve shifting more powers and program responsibilities among levels of government. Table 10.1 provides a snapshot of welfare state power distribution in 12 federal or federalizing countries. The data is extrapolated from a larger data set on federal power allocations derived from the Allocation of Powers Project of the Observatory of the Evolution of Institutions, University of Pompeu Fabru of Barcelona,

**Table 10.1** Allocation of welfare state powers in federal countries

AREA	Argentina	Australia	Austria	Belgium	Brazil	Canada	Germany	Italy	Mexico	Spain	Switzerland	USA
Labor/Social Law	EF	CN	OS	EF	EF	CN	CN	BF	EF	LF/EE	CN	CN
Economic Planning	EF	CN	OS	EE	OS	CN	CN	EF EE	OS	BF	CN	EE
Industrial Restructuring	EF	CN	EF	EE	OS	CN	CN	EE EF	EF	CN	CN	BF
Regional Development	CN	CN EE	EE	EE	EF	CN	EE	BF	CN	EE	EE	OS
Environmental Regulation	ML CN BF	CN EE	OS	EE	CN	CN	OS	EF	CN	BF	LF/EE	LF/EE
Environmental Management	ML CN	CN EE	OS	EE	CN	CN	EE	ML LF/EE	CN	EE	EE	LF/EE
Public Health Services	ML CN	EE	EF	OS	OS	EE	CN	BF EF	OS	EE	EE	OS
Basic Education	BF	EE	EF	EE	EF	EE	EE	EF	EF	EF	EF	EE
University Education	BF	CN EE	EF	EE	EF	EE	EE	BF EF	OS	BF	CN	EE
Retirement and Widows Pension	CN	CN EF	EF	EF	EF	CN	CN	BF EF	OS	EF	LF/EE	EF
Unemployment Payments	CN	CN EF	EF	EF	EF	EF	CN	BF EF		EF	LF/EE	BF
Poverty Reduction	ML CN	CN	EE	OS	CN	CN	CN	ML EE	OS	CN	ML EE	BF
Protection of Minors	ML CN	CN	EE	OS	CN	EE	EE	ML EE	OS	EE	CN	EE
Protection of Vulnerable Population	ML CN	CN	OS	EE	CN	?	EE	ML EE	OS	CN	EE	BF
Tourism	ML CN	CN EE	EE	EE	CN	EE	CN	EF BF	OS	EE	EE	EE
Promotion of Culture	ML CN	CN	OS	EE	CN	CN	EE	BF EF	OS	CN	EE	OS
Citizen Protection	ML CN	CN	OS	OS	EF	CN	ML	EF	OS	EF	EF	CN

Key:

**EF:** Federal exclusive power. The federation central government enjoys all public functions over a given subject matter.

**LF/EE:** Federal government exclusive power regarding the legislative and regulative functions over a given subject matter, and state\* government power regarding the administrative enforcement or the management of services established by state legislation (federal law and state administration).

**BF:** Federal government power regarding the principles and normative basis over a given subject matter, and state government power regarding all the other functions.

**CN:** Shared powers. Both levels of government enjoy normative power, but federal power prevails in case of conflict.

**EE:** State exclusive power. The state enjoys all public functions over a given subject matter.

**ML:** Local power.

**OS:** Other solutions (for instance, joint powers, joint powers on the basis of the territory or the subject matter, asymmetric allocation of powers, etc.).

\*State = constituent, e.g. länder, autonomous community, province, etc.

Source: Allocation of Powers Project, Observatory of Institutions, University Pompeu Fabru, Barcelona, Spain, 2003.

Spain (Argullol 2004). Some 17 welfare state programs have been selected (from over 90 in all areas) to illustrate the intergovernmentalization generated by welfare states. The programs selected include social services, education, economic and regional development, environmental protection, public health, income support, tourism and culture, and other aspects of social protection. The intergovernmental or overlapping powers are highlighted: LF/E or federal policy control and subnational administration, BF or federal normative power, subnational control over other functions, CN or shared powers, and OS, or joint or asymmetric powers.

Table 10.1 indicates that while some powers remain primarily within the domain of one government, most are of a shared nature. Of the 204 total cell entries, 162 show some form of shared powers. Of the 17 powers examined, federal countries intergovernmentalize an average of 13 (13.5), the range is from the least intergovernmentalized countries of Argentina and Brazil, with a host of countries at the high end of the spectrum: Germany, Canada, Australia, Switzerland and the United States. Few welfare state programs appear to be the exclusive province of any level of government, although basic education is exclusively federal in six countries and pensions and unemployment are exclusively federal in five countries. Although the nature of the power sharing is different – dual normative power, federal legislative and regulative powers and subnational administrative powers, or some form of joint arrangement – welfare state programs clearly demonstrate the shared nature of programs.

These working federations reflect an allocation of powers that requires “a balance between the independence and interdependence of the federal and regional governments in relation to each other” (Watts 1996: 31–2). As is demonstrated with regard to economic and social affairs, in some systems the design of administrative authority corresponds with the distribution of legislative authority, whereas in other systems jurisdiction is somehow divided. In either case intergovernmentalization brings on what Deil Wright (1988: 49) identifies as the overlapping authority model of interaction. In contrast to inclusive (total separation) or coordinate (top-down control) authority models, the overlapping model is characterized by: substantial areas of governmental operations involving several levels simultaneously; the areas of (complete) jurisdiction autonomy and jurisdiction are comparatively small; and, the power and influence of any one jurisdiction (or official) is limited, leading to exchange, negotiation and work towards agreements. The overlapping model in mixed, welfare state programs provides a platform for interaction based on jurisdiction.

### **Place, autonomy and the non-prefectural tradition**

Territory or place is a longstanding basis of governmental organization and political expression. It is one of the fundamental characteristics of any

polity. Sharpe (1987: 152–3, 156) indicates that there are four neglected political characteristics of territoriality. First, that the boundary of a polity, its extent and shape, may critically determine who is and who is not included and thus it determines the composition of majorities and minorities. Second, each unit or jurisdiction – nation-state, constituent second tier unit, or local government – is unique in the sense that its spatial location cannot be shared by any other polity. Third, an individual's location can determine shared collective interests as much as can ideology, occupation, religion or class. Fourth, the rule of scale in a democracy is often overlooked, which can affect the nature and quality of representation, distance to citizens, and efficiency in services. Territorial division and “territorial democracy,” as Elazar (1994b) suggests, is necessary in federal polities for maintenance of diversity within overall unity. Equality of political attachments needs to prevail in every territorial jurisdiction as a fundamental principle of organizing. Indeed, in regard to those federal systems that have experienced historically young polities – Australia, Canada, United States – they never had a premodern experience of any other form of organization but territoriality (p. 262).

The modern experience of territorial organization is inextricably bound with autonomy. Although it is not easy to define, it is clearly associated with the shared rule aspect of federalism (Agranoff 2004; Loughlin 2000: 10) and to devolutionary processes (Smith 1985; Fesler 1965). In a modern sense, it virtually always has a territorial focus (Rokkan and Urwin 1982). As Walker Connor (1994: 83) indicates, it is “capable of covering a multitude of visions extending from very limited local options to complete control over foreign policy.”

The development of modern local self-government in Western countries during the 19<sup>th</sup> century was partially to limit the intrusion of central governments in the affairs of communities; a clear expression of the bounded and passive state. Subnational units came to be established as recognized legal entities – jurisdictions – and while never intended to be completely free of central direction, their status led to the evolution of political, economic, and legal barriers to arbitrary central intervention. The assumption developed over a period of time that subnational units not only had freedom from interference from central officials but possessed freedom to do something to solve problems of the region or community (Sharpe 1987). As Kjellberg (1995: 43) concludes, “from originally being negatively defined, local autonomy became an instrument for the realization of communal interests, as well as a means to implement other values.” For example, a very famous 1983 Spanish Constitution court case involved a regional governments multiple challenge to a Parliamentary law that enabled the Cortes (parliament) to overturn their normative decisions. The Court upheld the challenge, as it determined that “autonomy means the possibility of making the final



decision in regard to devolved competencies" (Agranoff and Ramos 1997). In a federal context, autonomy is thus associated with forms of shared rule or dual governance, with each level to some degree able to decide on certain affairs independent of the other.

In actuality there are at least three forms of autonomy. The first, non-territorial or communal autonomy, is sometimes granted to widely scattered ethnic or religious groups where certain degrees of "functional" self-management is granted in educational, cultural, religious and sometimes juridical activities (Safran 2000: 12). Second, is devolutionary autonomy, or the transfer of power from central governments to autonomous units holding "corporate status" under state legislation (Cohen and Peterson 1999: 26). While these units often enjoy constitutional protection, they normally exercise delegated and/or concurrent powers and have more limited independent powers (Agranoff 2004; Zariski and Rousseau 1987: 33). The third type of autonomy is federal in nature, resting on covenants, compacts, and other contractual arrangements that divide powers between the levels (Elazar 1987: 33). Federal autonomy is associated with two distinct spheres of rule over the same territory and people with a constitutional guarantee of autonomy of each government in its own sphere (Riker 1964b: 11). Many systems that feature high degrees of devolutionary autonomy and constitutional protection have moved them in the federal autonomy direction, for example Spain (Agranoff 1996; Moreno 2001) and Italy (Fabbrini and Brunazzo 2003; Merloni 2003), and to some degree South Africa (Simeon and Murray 2001; Peeters 1994). In the case of Belgium, the state "differentiated" into a federal autonomy situation between 1973 and the adoption of its 1993 constitution (Fitzmaurice 1996).

The prefectural system with its use of *tutelage* in many ways stands in conceptual contrast to federal and devolutionary autonomy. While the concept of administrative guardianship originated with the Napoleonic administrative system in France in the 19<sup>th</sup> century, it spread to many countries of Southern Europe and to Turkey and Japan, among other countries. In its most basic form, a representative of the central state administration holds prior approval power over regional and local decisions, plans and budgets, and in some cases over many of the "details" of administering state programs within subnational governments. In most countries that used pure *tutelage* it has been partially or effectively set aside or attenuated and replaced by the gradual granting of autonomy, or by various means of weakening prefectural power.

Prefectural administration substantially remains in Turkey and presents a living example of the opposite of autonomy. *Tutelage* is a process that applies to all units of the state administration and to subnational governments. Constitutionally, the principle of *tutelage* goes to the "integral" aspect of the state and its administration, in Articles 123–127, with its

principles of central government and decentralization. As applied to local government Article 127 states:

The central government, for the sake of maintaining the provision of local services in harmony with the principle of the integral nature of the administration, securing the unity in public services, protecting the public interest and meeting the local needs as deserved by the local conditions has the power of tutelage (i.e. administrative control) to be implemented according to the principles and procedures to be stated in the law over local governments (Yasimis 1996–97: 74).

For example, the tutelage exercised over local government budgets includes both *a priori* and *a posteriori* control. A central government agent (usually provincial or subprovincial governor) has to ratify budgets before they can be put into effect (Guner 1994–95). This practice is true of most other actions and transactions of subnational governments, ranging from internal reorganization to all purchasing. In addition, many issues that involve capital expenditures and flexible interpretations of normative issues can only be approved by the central ministries. It is estimated that on a given working day, upwards of 100,000 local officials and managers visit Ankara to seek such permission. Tutelage in Turkey is supported by hundreds of laws, decrees, regulations and administrative circulars which regulate local and regional authorities.

The reason why prefectural administration has given way in most countries where it was employed is to promote self-rule among subnational units. Japan, for example, has a history of tight central fiscal and program control over its prefectures, but also a set of vertical linkages based on intergovernmental relations has emerged (Reed 1986: 34). Since 1990, it has tried to transfer control downward to regions and large core cities under the Regional Devolution Act and Law for the Promoting of Decentralization, both enacted in 1995. Although reform has been slow, regional and local authorities are emerging as the major providers of education and social protection services. They have also gained more decision control over public works and development projects. Lagging behind is the control by the central state over the “enormous volume of transfers which dwarf the significance of fiscal resources controlled by the subnational governments” (Jinno 1997: 20). This leaves substantial control in the hands of the bureaucrats in the Ministry of Finance. Nevertheless, the central government has committed in principle to abolish *kikan inin jimū* (agency-delegated functions) carried out by prefectural governors, mayors, and administrative committees to build “a new intergovernmental relations based on the principle of equal partnership” (Masujima 1999: 176).

The essential concern is that in a non-prefectural situation of subnational autonomy the principle of prior approval does not exist. Of course, this is

particularly true with regard to federal autonomy. Prior approval gives way to different forms of non-intervention and after-the-fact review and/or forms of less formal interaction during intergovernmental program transactions. To a considerable degree, compliance is a matter of informal or internalized acceptance of the legal and regulatory authority of the higher level government. To be sure, there is a "zone" of mandatory rules and controls that are based in law and regulations, and subnational governments face degrees of normative guidance. What is less well understood is that intermediate and local governments also have a considerable zone of freedom to act within the framework of national (or state) legal powers.

In practice many action alternatives exist for subnational governments and the administrative practice seeking prior approval is quite rare. In the Agranoff and McGuire (2003: Ch. 3) study of local government intergovernmental transactions, five response modes were found to prevail: (1) total avoidance or abstinence; (2) strict compliance without monitoring; (3) minor interaction, information and accommodation; (4) major bargaining and negotiating with higher governments, and (5) advancing the jurisdiction's own program agenda or comprehensive program that entails locally initiated major adjustment. A sixth possibility, not evidenced in the study, would be open defiance or failure to follow a standard or regulation. This is often followed by litigation or other means of judicial dispute resolution. There could be many more possibilities. What is important about these *possibilities* is that under autonomy, after a normative/framed contract or plan is negotiated and accepted for an intergovernmental program, prior approval is virtually non-existent or occurs over minimal concerns. Jurisdictions are generally free to act within broader legal and regulatory stipulations as they "receive" and administer external programs within their own jurisdictions.

Under these conditions, there is considerable "give and take" in the processes of exchange among autonomous governments, as the policy implementation studies involving federal grants reveal. Conceptually, this type of policy interaction was initially captured by Jeffrey Pressman in his study of federal aid to cities. He reminded us that "Donor and recipient need each other, but neither has the ability to control fully the actions of the other. Thus, the aid process takes the form of bargaining between partly cooperative, partly antagonistic, and mutually dependent sets of actors" (1975: 106-7). Helen Ingram's (1977) study of environmental programs concluded that these programs are not necessarily instruments of federal control but opportunities to bargain. While federal officials would like to bind state and local program managers to federal policy, subnational governments seek the maximum possible leeway to pursue their own separate goals and objectives with federal help. Similarly, Liebschutz (1991) depicts an intergovernmental fiscal system in New York as one defined by bargaining and negotiation. In social services programs, as Richard Elmore

(1987: 36) concludes: “this give and take has become a managerial strategy in the implementation process. [The] bargain is a two-way affair, inherently different from hierarchical control. A contract is not an instrument of coercion.” It is a managerial game that, according to Williams’ study of manpower and community development (1980: 197), “requires ... subtle skill and much knowledge about the roles, the players, and available strategies in the federal-local bargaining situation.” Thus, not only are extended chains of connections established through autonomous governments, but complex relationships are established over the management of these programs.

### **Complexity and the need to operate collaboratively**

The normal processes of intergovernmental policy management are protracted, odious, and often tedious, and without a doubt bring on frustration in some circles, lack of interest in others, and sometimes both (Poirier 2002; Sharkansky 1981). Is it always that way? Clearly, under conditions of simple transfer of power upward or downward, few complicated intergovernmental processes would follow. For example, in the 19<sup>th</sup> century when the US federal government preempted state activities in setting interstate transportation rates, states no longer were involved in these activities. They became a matter of federal policy-making and administration. On occasion, federal governments have merely turned over or affirmed program responsibilities to constituent units and then substantially removed themselves from a policy arena. In other cases central governments choose not to act in a policy arena or they are constitutionally limited from acting. These processes are not unknown in Canada (Watts 1996), e.g., in education and environmental policy and occur with increasing frequency in decentralizing federal Belgium, e.g., in education, agriculture, economic development and foreign trade (Fitzmaurice 1996).

But rarely are such processes so neatly compartmentalized. The typical public policy effort is interactive, even when most elements of it are normatively and administratively transferred downward. For example, the Spanish broad (block) grant for social services follows that of many other European meso government social programs (Moreno 2003) in that the center transfers money downward to regional governments and from them to municipalities based on regional decision and contracted operations with NGOs. But some services are based on an “Agreed Plan,” with national needs (e.g., domestic violence, substance abuse, settlement of immigrants), along with a set of fiscal and program reporting requirements. The “Plan” is negotiated between regional/local officials and the Ministry of Labor and Social Affairs, and then introduced into law. Reporting and auditing is limited. The Spanish “Agreed Plan” is an example of a “minimal” intergovernmental

program that is largely the province of regional governments (Chacón 1995).

Programs that have been around for some time and have protective constituencies are considerably more engaged. An example is Title III of the Older Americans Act of 1965, which provides various types of services to senior citizens in need through a network of regional Area Agencies on Aging (AAA) and their service contractors. The Act is on a five year renewable cycle, and is subject to intense Congressional lobbying by advocates and elder social welfare and medical professionals. Each part of the title is subject to multiple pages of program regulations and subsequent guidelines that fill many booklets. The federal government's Administration on Aging must approve and later monitor each of 56 (states and territories) "state plans," which are actually contracts for the federal money. There are many additional requirements to the program requirements, e.g., non-discrimination, protected category business "set-asides," how federal programs are to be organized and categories of expenditures. The states, in turn, put their own legislative and administrative procedures (e.g., service priorities, purchasing, travel/reimbursement) on the process, as they contract with the AAAs, who in turn make plans and arrangements to deliver home nursing, nutritional, day activity, home helps, visitor and other services to seniors in need. At each stage of the process both fiscal and program paperwork is compiled and sent from contractor to AAA to the states, because the state is subject to a dual (program/fiscal) audit some two years after the close of the fiscal year in which services are delivered. In such a process lots of interactions and transactions take place, mostly requiring cooperation, but not without some measures of conflict as well.

The Older Americans Act Title III may seem like an extreme example, but in the United States it is typical of hundreds of the some 1,100 domestic programs listed in the US Catalogue of Domestic Federal Assistance to State and Local Governments. Other federal governments follow similar patterns for some programs. Federal governments do operate other policies more like the Spanish Social Services model, where there is substantially more flexibility "down the federal line," so to speak. It is important to recall that even the Spanish example retains important elements of political and managerial cooperation, fiscal and programs reporting, along with many opportunities for deciding and managing the details along the intergovernmental chain from central ministry to contractee.

These involved policy processes are often thought of as highly federal but actually exist in virtually all systems, unitary and federal. In contemporary welfare states both experience high levels of policy intergovernmentalization. For example, in a study of British and French tourism and regional development policy (Armstrong and DeKervennoael 2000) it was found that five levels – European Union, national government, regional government, county department, and local levels (including NGOs) – were substantially

involved in both financial responsibilities such as revenue raising, budgeting, and spatial targeting and functional allocations like setting the terms and operations of programs. As a result of the substantial involvement of so many tiers, "responsibility" was impossible to assess. On the other hand, multiple involvements enhanced certain delivery system efficiencies, such as financial targeting, policy knowledge and economies of scale at "higher" levels and networking opportunities and capacity for innovativeness at regional and local levels. These processes lead to the establishment of inter-governmental mechanisms. In this intergovernmental fashion, non-federal processes look more like those of federal countries.

### **Macro IGR**

When the concept of IGR was new scholars began to talk about the means of "cooperative federalism." Because the bulk of administrative work has to deal with local citizens' services there is a notable local presence of central government programs, but through regional and local governments. Indeed, from times earlier than the development of 20<sup>th</sup>-century welfare states, national governments used their superior resources to initiate programs administered by subnational governments (Elazar 1962; Grodzins 1966: 17; Skocpol 1995).

In a not untypical fashion, the US federal structure stands as an example of this pattern. The US remained decentralized from its colonial-post independence roots because Congress, with its state and local constituencies, has reinforced legislation that implements national policies at state and local levels. National administrative structures have rarely supplanted the powers of state and local government (Skowronek 1982). As multi-tiered processes were studied from the 1930s to the 1960s, IGR scholars found many mechanisms of interaction. The "cooperative" federalism process found by two groups of scholars, at the University of Chicago and the University of Minnesota in the US pointed to intergovernmental operations based on federal (and state) specified funding, standards, and minimal supervision over state and local planning and performance. William Anderson (1955: 201) of the University of Minnesota group found a great deal of working together and an absence of "crack-down" orders in some 81 federal-state programs. Indeed federal involvement was said to enhance state administration, including the creation of new state agencies and the enlargement of others, new state civil service systems, increased state planning efforts and increased opportunities for interstate (or horizontal) cooperation (Anderson 1960: 62). The University of Chicago group characterized the process as involving national supervision within considerable state and local discretion, through mutual accommodation and joint agenda-setting, despite some conflicts and resistance to federal and in some cases federal and state control (Grodzins 1966: 373).

IGR has moved well beyond the heady days of cooperative federalism into more complex and involved means of interaction. The example in the previous section, involving Title III of the Older Americans Act, illustrates that along with residual cooperation that still exists (Agranoff 2001a), are administrative, financial, legal and political practices that constitute the type of indirect supervision or regulation identified earlier. There are many ties and concerns of politics, money and the law. The US example is not unique. A wide range of IGR instruments exist in most of today's federal systems and they are administrative, political, economic and legal.

Figure 10.1 lists 27 of the more commonly used IGR mechanisms that are extensively used in the 25 or so federal countries, including such countries as Italy, South Africa, and Spain that have significant federal features, particularly constitutionally-based regional autonomy (Agranoff 2004). Their existence varies from country to country and program to program. They are not listed in any particular order of importance. It is also difficult to stipulate that some are exclusively political, economic, legal or administrative. Nevertheless, among the more important economic mechanisms are the various forms of subventions or grants, tax efforts like shared taxes, tax forgiveness/reciprocal taxation, fiscal auditing and accounting, intergovernmental loans, and intergovernmental fiscal equalization commissions. Among the more important and widespread legal mechanisms are regulations imposed by higher level governments on subnational governments, cooperation and intergovernmental agreements among governments, reciprocal or interdependent legal actions (e.g., EU social policy and the many organic laws governing subnational governments). There are several important political instruments, including various intergovernmental councils, first ministers conferences in parliamentary federal systems, sectoral conferences, the second legislative chamber in countries like Germany and South Africa, forms of intergovernmental contacts and lobbying by individual officials and by associations, and through the use of internal political party channels to advance intergovernmental interests. Finally, the most notable administrative instruments include contracts for services, program assessments or audits, negotiation for performance or results in exchange for controls, and various forms of placed-based or regional management at the horizontal level (below). Again, the four fold categorization is somewhat artificial. There are economic concerns at the heart of all of these interactions. It is hard to remove politics from virtually any intergovernmental action. Virtually all economic mechanisms are based somewhere in law. Organic intergovernmental law reflects the product of highly political processes. And so on.

From the standpoint of intergovernmental policy we are primarily concerned with how these instruments serve managerial cooperation within policy systems. First, they are either formal mechanisms or formalized patterns of behavior that link independent governments. As linking



mechanisms they acknowledge *interdependence* of governments in sets of policy systems. Second, they tend to be continuing processes that link governments from day-to-day and year to year. These are not normally one-time actions but officials become used to dealing with one another through these mechanisms. Third, while they have been identified as instruments and actions, behind them are the individuals who act on behalf of their governments. As Anderson (1960: 11) once asserted, strictly speaking governments do not have relations, but entail "human beings clothed in office that act on behalf of their governments." Fourth, as mentioned, these mechanisms serve programs or have policy intent behind them. For example, fiscal transfers do more than transfer operating funds, but are normally designed to serve some form of fiscal equalization. The audit requirements in the Older Americans Act are designed to see that the target population receives the proper mix of services, as designed in the framework legislation. Fifth, IGR instruments primarily involve the interactions of administrative officials working out the details and procedures of broader public policies. While elected officials, i.e. politicians, often do become involved in some negotiations, accommodations and agreements, the bulk of the interactive mechanisms occur after basic policies are framed, and are conducted by appointed program heads and their staff. Finally, a sixth characteristic is that from a constitutional law, fiscal federalism, public policy, and public administration standpoint these intergovernmental instruments are translatable into "researchable patterns" that can contribute to a body of IGR knowledge related to policy management. Such bodies of knowledge are constantly being added to on both a country (e.g., Wright 1998; Galligan 1995; Rhodes 1997; Oates 1999; Walker 2000) and on a comparative basis (Agranoff 1992; Bennet 1990; Elazar 1987; Nathan and Balmaceda 1990; Watts 1996).

### **First minister's and ministerial conferences**

An often utilized intergovernmental practice in federal and profederal systems that is primary political and somewhat administrative, called "executive federalism." Watts (1996: 52) defines this practice as "the predominant role of governmental executives (ministers and their officials) in the intergovernmental relations in parliamentary federations where responsible first ministers and cabinet ministers tend to predominate within both levels of government." In some cases, dedicated subject matter conferences led by cabinet ministers, e.g., finance, environment, economic development, social services are called sectoral conferences. Executive federalism bodies and workings normally develop pragmatically rather than by constitutional requirement, but in Canada, Australia, Germany, India and Malaysia they range from joint councils or meetings, to all-important first ministers, (e.g., Prime Minister and provincial premiers) conferences. These



1.	<p><u>Economic Devices</u></p> <ul style="list-style-type: none"> <li>■ Grants or subventions (General Revenue/Unrestricted; Broad/Bloc; Targeted/Categorical)</li> <li>■ Fiscal audits (look behind reviews).</li> <li>■ Tax policies (reciprocal taxation schedules; tax abatements/forgiveness; tax sharing; tax transfers; tax cession).</li> <li>■ Intergovernmental loans.</li> <li>■ Shared (with private sector and other governments) capital projects and investments, shared venture capital investments.</li> <li>■ Intergovernmental fiscal study/equalization commissions.</li> <li>■ Procurement of goods, services, personnel from other governments.</li> </ul>
2.	<p><u>Legal Approaches</u></p> <ul style="list-style-type: none"> <li>■ Intergovernmental Regulation (program requirements, crossover rules, crosscutting requirements), executive orders, direct regulation, partial preemption, total preemption by higher level government.</li> <li>■ Cooperative agreements to jointly operate a program (health statistics, emergency management, internal security).</li> <li>■ Intergovernmental agreements (joint fire services, combined libraries, special education cooperatives, mutual aid for police emergencies).</li> <li>■ Interdependent legal actions (EU social policies, joint workplace regulation, joint income tax format agreements).</li> <li>■ Organic laws on governmental structure, local taxation, local civil service, local competencies.</li> </ul>
3.	<p><u>Administrative Practices</u></p> <ul style="list-style-type: none"> <li>■ Program standards and requirements.</li> <li>■ Contracts for services/programming between governments.</li> <li>■ Exchange of personnel.</li> <li>■ Program audits (look behind review).</li> <li>■ Regional/metropolitan governments or special authorities.</li> <li>■ Negotiated performance programs (in lieu of controls and requirements).</li> </ul>
4.	<p><u>Political/Government Bodies</u></p> <ul style="list-style-type: none"> <li>■ Intersectoral/intergovernmental networks and councils.</li> <li>■ First ministers' conferences.</li> <li>■ Sectoral conferences (environment, economy, education).</li> <li>■ Councils of governments (regional, metropolitan).</li> <li>■ Parliamentary second chambers.</li> <li>■ Intergovernmental associations (municipalities, provinces, mayors, local councils, local civil service unions, corps of civil servants).</li> <li>■ Intergovernmental lobbying/representation.</li> <li>■ Elected official to elected official contacts.</li> <li>■ Political party channels.</li> </ul>

*Figure 10.1* Twenty-seven instruments of intergovernmental relations

meetings, Watts (1996: 52) observes, provide “institutional processes for consultation, negotiation, cooperation and, on occasion, joint projects.”

In countries where executive federalism is prevalent, governments have also established internal specialized units to coordinate the agreements, policies and programs that emanate from these bodies. Clearly one of the

most developed manifestations of executive federalism occurs in Germany, with the *Bundesrat* and its committees serving as the focal point for such intergovernmental operation. Watts (1999: 275) states that "It serves as an intergovernmental institution facilitating cooperation between the Bund and the Länder where the constitution for large areas assigns legislative authority to the former and executive authority to the latter ... the Bundesrat serves as a device for the effective representation of Länder views within national institutions ...." It is also important to note that in Presidential systems where legislative and executive powers are dispersed, e.g., US, Brazil, Russia, political channels are also more dispersed, and executive federalism rarely operates in this organized fashion. In unitary countries, this phenomenon is rare, primarily because of the absence of an elected second tier, where functions are less divided either constitutionally or in administrative practice.

Canada is the federal parliamentary country where executive federalism is most prominently practiced. Provincial governments have a great deal of independence, and they often use executive federalism to resist the federal government's use of superior spending power to advance national policy, which they argue amounts to coercion. As a result, such jurisdictional strength and resistance to federal encroachment amounts to what Richard Simeon (1980) refers to as "political independence/policy dependence." This has led to the extensive use of this mechanism:

Federal-provincial conferences in Canada have been raised to a fine art and the media duly note the drama, conflict, compromise, and coercion that occur. This extraconstitutional manifestation of executive federalism has led to attempts to constitutionalize a requirement for a yearly conference (now referred to as First ministers conferences) in the most recent failed efforts at constitutional reform. At least two or three conferences at the highest level already take place each year. Although there is no legal veto power, it is nevertheless clear that the extensive federal-provincial negotiation that occurs during the development of public policy circumstances, in a de facto sense, the exercise of executive power that is so prevalent in a British Parliamentary system. Thus far, such negotiation has served to restrain federal power to a greater extent than provincial power, since the federal government feels constrained to consult provincial governments even when developing policy in an exclusive federal jurisdiction (Radin and Boase 2000: 72).

This mechanism has become so institutionalized that Canadian provincial governments have successfully "asserted their right to be consulted by Ottawa in respect to a range of matters of trade and tariffs and interprovincial transportation and communication" (Smiley 1987: 85), matters that are exclusively federal.

Negotiation and adjustment of fiscal relationships – taxation levels and assignments, fiscal subventions, expenditures – are among the most prevalent uses of executive federalism. Ronald Watts' (1996: 49) comparative study of ten federations/proto federations concluded that seven use a form of executive federalism to resolve finance issues. Australia uses a Premier's Conference and their Loans Council. Canada uses finance ministers and prime ministers conferences. Germany uses finance ministers and the Bundesrat. India and Malaysia use both premier/governor's councils and sectoral finance commissions. Since 1997 South Africa has operated with a statutory Budget Council, which focuses on provincial financial matters. It involves the minister of finance, who chairs the council, as well as the nine provincial finance directors or MECs (members of executive council), five representatives of nationally-based local government organizations, and one local representative nominated by each provincial government. This body deliberates matters of subnational finance, which are then transmitted through the Ministry of Finance to the cabinet (Wehner 2000).

Australia operates with several executive vehicles, including annual Financial and Special Premiers Conferences. The latter are designed to facilitate joint efforts in areas where cooperation is needed. Special Premiers Conferences bring together interim reports of working groups of state and commonwealth officials, who conduct joint reviews of financing, regulation, services delivery and other responsibilities of the levels of government. A wide range of subjects have been part of these Special Conferences; functional responsibilities in health and social services, microeconomic reform of regulation and government businesses, provision of public infrastructure, transportation and environment. These meetings normally alternate with the annual Financial Budget Premiers Conferences (Galligan 1995: 206–7). Since 1992, Australia also operates with a Council of Australian Governments (COAG), a twice a year forum for continuing discussion of issues not covered by the other meetings between premiers and the prime minister, along with the president of the Australian Local Government Association. COAG has been a most important body for exploring major policy departures that affect all levels of government. For example, COAG was instrumental in reaching consensus regarding Australia's need for making those reforms needed to make its economy more globally competitive (Galligan 1995: 211–13).

COAG thus emphasizes non-financial matters in Australia, where the Commonwealth government is less dominant, particularly those that are state, and state/Commonwealth responsibilities. It is considered to be a forum for dealing with long-term issues, where norms of cooperation prevail over those of competition and/or conflict. It operates through many standing committees and working groups, and at times has enabled special Ministerial Councils (Henderson and Edwards 1995). Patrick Weller's (1995) study of COAG's first few years suggests the importance of

that body's: (1) focused attention to the appropriate stage of the policy process; (2) commitment to cooperation as well as politics, and (3) focus on concrete changes that incorporate cross-jurisdictional views. The "best practices" he found in such joint policy-making included: good preparatory work before a COAG meeting; agreement on an item's importance; a rolling agenda of substantive issues; perceived mutual benefit and mutual pairing of officials; a range of mechanisms to ensure progress in negotiations; regular meetings and reiterative consideration of items; a champion for each issue; frequent confirmation of mandates; and continuing successes, however small. This process was followed in seven different policy areas, in which the broad context was determined by "political demands," yet in COAG the areas of reform are often within states' areas of competence and require Commonwealth-state cooperation (p. 1).

Many other countries employ special conferences similar to Australia's Ministerial Conferences. Spain, for example, has a long history of using sectoral conferences to articulate AC and central governments political and administrative issues. These conferences range widely in issues, for example in social affairs, education, fisheries, transport, culture, tourism and environment. They have met with mixed success. Since 1994, with an agreement of participation by AC's in European community policy-making, some 16 European related sectoral conferences were identified as means of facilitating this new process. Tanya Börzel's (2000) study of 23 sectoral conferences, European and domestic, revealed that multi-lateral intergovernmental cooperation was more effective on issues related to European policy than on those of domestic issues. Nevertheless, the sectoral conference stands as a potentially important means of cooperation.

## Joint policy-making

Intergovernmental policy-making is a part of the political process in most multi-tiered systems. Such multi-level involvement in the "up front" creation of programs and policies, has been labeled as joint policy-making by observers of that process in Germany. In this process the affected parties engage in formal or informal "shared" decision-making to develop or revise policy. As programs are increasingly centrally sponsored but operated by subnational governments, intermediate and local governments plus NGO agents find that the corresponding interdependence generates a great need for interaction beyond the traditional "we propose" and "they dispose." A more concerted action, where the affected parties or their representatives move beyond the initial enactment/authorization and forge out workable courses of implementation, is called for (Agranoff 1992). As Hanf (1978: 3) states: "the ability of individual decision units is so dependent on other units, as well as their own choices, that the major task is serving coordinated policy actions." As a result, collaborative policy development engages

higher level governments in an IGR process with subnational agents, overcoming their traditional posture with legal compliance checks, rule enforcement, and fiscal audits. Kaufman (1986) maintains that the quest for "guidance, control, and evaluation" is a direct function of intergovernmental interdependence.

Nowhere has this process been put to the test more than in Germany, where the federal government effectively has no implementation machinery but those of the *Länder* and local governments. Hesse (1987) described IGR in Germany as involving a process of transforming traditional federalism into joint policy-making, where actors from the different levels of government pursue their own interests interactively while developing domestic policies. The decision venue has largely been the Bundesrat, where the *Länder* governments have direct representation. The politics of distribution and equalization gradually drew the *Länder* governments into a centralized policy process (Klatt 1999) due to: constitutional establishment of joint tasks; intensification of the federal government in concurrent policy areas; extension of co-financing of major projects; and a system of pooling the major taxes of the federation and the *Länder*, which restricted *Länder* discretion (Strum and Jeffery 1992: 165; see also Benz 1999; Mackenstein and Jeffery 1999). In addition, Germany remains committed to the principle of social and economic solidarity, where the unique process of fiscal transfers from larger/richer to smaller/poorer states regularly equalize fiscal burdens.

The process of joint policy-making has not led to complete satisfaction. Consensus politics has been used for the weaker/smaller *Länder* to protect their interests before the stronger ones. Joint decision arenas were said to restrict policy outputs to the *status quo* (the default solution if no "consensual" alternative can be found) or to those changes made acceptable to all parties, often through special line-item "bribes" to the dissatisfied. Nevertheless, because the *Länder* had committed themselves to joint responses, *Länder* forfeited their right to legislate potentially more beneficial solutions for their own land (Adelberger 2001: 51). This dilemma is what Fritz Scharpf (1988) has identified as the "joint-decision trap," that is situations where beneficiaries of the *status quo* can block all reforms, or at least extract exorbitant side payments. The trade-off for joint policy agreement is widely believed to be loss of autonomy. Scharpf (1996: 365) concludes that joint policy-making coupled with the goal of achieving inter *Länd* uniform living conditions has led to making Germany a "unitary federal state." "In political terms, it is fair to say that *Länder* governments have traded their autonomy for political influence at the federal level" (p. 366).

Notwithstanding the very real dilemmas of the "joint-decision trap," the notion that subnational units can influence the details of policy at the formulation stage remains an intergovernmental political move that provides considerable potential. In particular, it works well when a pilot program is being transformed into a broader effort. When the State of Kentucky in the

US administered the small cities CDBG on a pilot experimental basis in the late 1980s, the state director built the program by employing the participation and advice of a technical committee and by a policy committee to design selection criteria and to establish program guidelines. The committees were comprised of local officials and area development district administrators. Also represented were major local government association and state officials from related program departments, and federal officials from HUD. The latter set of officials worked closely with state-level officials at all stages of the process: in setting program parameters, training procedures and on-site visits. The result was not only a more workable policy, but "this joint process strengthened federal-state relations" (Howitt 1984: 91). Many of the experimental provisions were put into the legislation and regulations when national enactment ensued in 1991 (Jennings *et al.* 1986).

A more recent example involves the US Rural Development Councils established in 1990, comprised of federal, state, and local government officials, as well as non-government association representatives. Their charge is to define rural issues relevant to their settings, and for federal officials to use their discretion to maximize collaboration and cooperation. A pilot group of eight states has been expanded to nearly 40. Most Councils engage in some form of joint policy-making, particularly: discovering and expanding discretion, methods to generate greater involvement and collaborative decision-making, and development of new channels of communication and personal relationships. In some cases the intergovernmental parties have worked together to make allocation decisions, consolidated a multiple agency loan application process, located a youth employment facility, developed a state infrastructure development agenda, and unlocked a water resources dispute over recreation versus navigation on a major river (Radin *et al.* 1996).

As the US examples suggest, collaborative policy-making works best on programs where those who implement them have first line experience that can be transformed into program knowledge can be fed back into policy design, and are involved in policy formation. Moreover, the same actors play a very important role in subsequent execution and feedback. As mentioned, the Social Service Mixed Commission in Spain uses a near identical method to revise its Broad Grant program for autonomous communities. Basically, local, territorial and central officials meet periodically to revise the "Agreed Plan" for Social Services Provision. There are both technical and program panels, who look back at the experience of the past few years, and agree upon recommendation for revisions that are transmitted to the Cortes and the Directorate Social Affairs. All territorial officials agree to a minimum floor for basic services, beyond which each has considerable discretion (Chacón 1995). It therefore offers the best of two worlds, uniform national basic coverage plus discretionary actions based on regional needs and priorities. The national program becomes less of a "mandate" because

it is agreed upon, and funds are not completely tied to hewing a central tone, hopefully engendering more cooperation down the line at the administrative or implementation phase.

### **Horizontal federalism: interstate/intergovernmental relations**

Although less visible than vertical IGR, all federal systems generate relations among constituent units, both constitutional/legal and informal. Constitutionally, inter-unit relations normally include provisions for settlement of disputes among units, authorization of cooperative actions and agreements, and regulations regarding respect for legal acts and commercial practices among states/provinces. In regard to policy coordination, some horizontal IGR practices emanate from constitutional authorizations, but a larger set of extra legal practices also have emerged as the need for lateral coordination arises.

In Germany, for example, although the Bundesrat would serve as an informal venue for horizontal collaboration, there are no constitutional organs for inter-Länder cooperation. Länder do form conferences and other mechanisms if the collaboration is within the competence of the Länder. One example is the Permanent Conference of the Ministers of Education (Kluth and Franz 2003). In Canada there is at least one annual conference (or meeting) of provincial ministers in most policy areas. One example is the Canadian Council on Resource Ministers, now Canadian Council of Ministers on Environment. It is a research and advocacy body that tries to harmonize interprovincial cooperation (Brown-John 2000). As mentioned above, Australia engages in joint policy-making through various ministerial conferences, where the states and the federal government are represented, and many informal types of horizontal collaboration are engendered.

Underlying such formal arrangements are informal consultations between officials at the state/provincial level. Officials often call or visit counterparts in other units, particularly neighboring units, to learn how to deal with a policy problem or meet a new challenge. Zimmerman (1998) reports the regular practice of cooperation among state attorneys general, including working together on investigations (e.g., unsafe products), jointly filing lawsuits (e.g., false advertising claims), and *amicus curiae* briefs (e.g., tobacco settlements). State officials may also consult with an association, such as the US Council of State Governments, or one of their publications in their Innovations series, or the heavily referenced *Book of the States*.

One critical aspect of informal cooperation relates to a future action of one unit that may affect another unit, such as construction of highways and bridges across borders or flood control projects that have interunit implications. Sometimes there may be cross-border cooperation regarding employment and economic development policies, such as when a large assembly plant is to be located near the border of two units. For example,

the governments of Wisconsin and Illinois jointly developed workforce development policies, when the Motorola electronics firm located a 4,500 employee plant in Harvard, Illinois, just five miles from the Wisconsin border.

Another important type of informal cooperation occurs when officials at state/provincial levels work together to exert leverage on their federal government. For example, in Spain in 2000 the presidents of three autonomous communities (Castilla-LaMancha, Andalucía, Extremadura) worked together to insert a "hold-harmless" provision into a new tax sharing agreement for the regional governments, so as not to fiscally penalize their below average per capita income regions after the national government introduced an income tax sharing arrangement that would have severely disadvantaged them.

Finally, cooperation may exist through personnel exchanges to help neighboring units meet a major challenge of managing policy and inter-governmental programs. In Germany, some 8,400 western Länder officials worked in eastern partner administrations during the merger of the former east German Länder with the west. They provided a vital form of administrative expertise, and even introduced new, less restrictive routines than western practices. According to Goetz (1999: 92), they were part of the "complex network of cooperative arrangements through which western financial and material resources, legal and practical expertise, and perhaps most importantly, personnel were made available to administrations in the East."

In the United States two other informal practices are important aspects of cooperation. The first is reciprocal state court actions, a sort of "Common Law" of the states. In these situations, the courts in one state are guided by the decisions of courts in other states. Even if the decisions or rulings are different, courts may be somewhat guided by the situations where similar facts have been presented. The American Law Institute periodically publishes a reference volume that highlights the major points of agreement in the decisions of various state courts on the same subject (Zimmerman 1992). A second practice is the interstate movement toward uniform laws. In an informal way states borrow statutes from each other. Since 1892 there has been a National Conference of Commissioners on Uniform Laws. It meets annually, with three lawyer representatives appointed by each state governor. Its most widely known success is the Uniform Commercial Code, ratified by all states but Louisiana, that governs bank checks and money transfers and sale of goods over \$500. Other codes govern business practices, highway traffic, domestic violence, substance abuse, and commercial credit.

Interstate or interprovincial agreements make-up a large portion of formalized horizontal intergovernmental policy agreements. Florestano (1994) describes an interstate compact as legal document that combines the attributes of a state statute and a contract. She defines it as a legal agreement



between two or more states entered into in order to deal with a problem or concern that crosses state boundaries. It takes precedence over prior law and subsequent legislation, is binding on the states, and is enforceable in federal and state courts (p. 14). An example of an interstate compact is the Australian Mutual Recognition Scheme, which enables mobility of labor between states and removed non-tariff barriers to trade in goods across borders, in effect creating a national market. It was subsequently agreed to in COAG, and implemented in state and Commonwealth legislation (Saunders and Leroy 2003). In Italy's recent constitutional reform, regions have the right to stipulate agreements "in order to exercise their functions better, also with the establishment of common organisms" (quoted in Merloni 2003: 15). This should open up the practice of interregional compacts.

Policy coordination is just one of several reasons why constituent units compact. Voit and Nitting (1999) list seven additional overlapping purposes to: create a multi-state public authority (e.g., port, transit), establish uniform guidelines or procedures for agencies in respective states, create economies of scale, comply with federal law, preclude federal action, promote regional interests, and, settle disputes between states. Bowman's (2004b) data in some 150 US non-bilateral, non-border multi-state compacts reveals that the average state belongs to 23.4 such compacts, ranging from a low of 14 to a high of 32. Only two have all 50 states as members: Interstate Compact on the Placement of Children and the Uniform Interstate Compact on Juveniles. Other policy-related compacts include the Compact on Mental Health, Low Level Radioactive Waste Compact, Corrections Compact, Interstate Adoption, and the Interstate Compact on Supervision of Parolees. Several states have also entered into compacts to manage and preserve river basins, allocate scarce interstate water sources, promote regional economic development, and to share institutions and programs in specialized higher education (Florestano 1994).

In the US, states also enter into administrative agreements of various types, often to supplement interstate compacts. For example, the governors of Georgia, North Carolina and Tennessee signed the "Southern Air Principles" in 2001, which directed their states' environmental agencies to work together to develop a regional plan to address pollution problems in the Southern Appalachian Mountains. Maine, New Hampshire and Vermont created a state-level prescription drug purchasing pool in 2001 by interstate administrative agreement (Bowman 2004b). These cooperative agreements also extend to purchasing many other items. DELMARVA, an agreement between Delaware, Maryland and Virginia, cooperatively purchases motor vehicles, highway salt, light fixtures, and insecticides.

Finally, associations of state officials are important in furthering cooperation, particularly in non-parliamentary countries like the United States where executive federalism does not normally operate. These interstate

associations include those that include the state as a jurisdictional entity, for example the Council of State Governments or the Conference on State Legislatures, to those representing state officials, such as the National Governors Associations (NGA) and the National Association of Attorneys General (NAAG). There are several other groups of state officials. These groups vary in function, but most engage in research, information, mutual service, workshops, training, and conferences and many are active in lobbying or in other advocacy activity. The NGA can be a powerful lobby group. For example, in 2003 it resisted President Bush's Medicaid (federal-state medical payments assistance) reform proposals and the administration retreated. A bipartisan committee of seven governors was appointed to negotiate a solution with federal officials. Another active organization is NAAG, which has adopted policy positions regarding state actions in anti-trust, civil rights, consumer protection, criminal law, environment, gaming, health, and insurance. It has also lobbied Congress on many issues, e.g., regulation of gambling on Indian reservations. Finally, NAAG cooperates with federal agencies in areas like consumer fraud, with the Federal Trade Commission and with the American Association of Retired Persons in preventing telemarketing fraud (Zimmerman 1998).

Horizontal IGR is not a widely studied phenomenon. Working on interstate compacts, Florestano (1994: 17) notes that interstate relations seems to be dropping out of studies of federalism. But its practice is of continuing importance, and with some exceptions (Zimmerman 1996; Bowman 2004b) deserves greater intergovernmental research attention.

### **Micro IGM**

Post-enablement actions in the implementation and assessment stages need to be taken into account for a complete analysis of policy management within federal cooperation. These processes unfold through multiple tiers of government and the non-public sector. These are the micro processes of IGM, that is, those behaviors of officials representing jurisdictions in policy processes.

These actions are largely hidden from public view as officials work out policies on a day-to-day basis. As defined earlier, IGM involves the solving of problems through networks of actors, primarily the work of administrators. As a sub activity of IGR, it is a means of coping and working within the existing system, deals with regular and routine contacts and transactions, and entails joint actions of officials dealing with jurisdictional-legal, political, technical issues while some project or task is being accomplished (Agranoff 1996). It is also important to account for the conditions under which IGM operates, those of: partial accountability; the likelihood of differing objectives held by the various jurisdictions; programming of an ongoing or continuous nature; and, exchanges of resources, information and power across organizational boundaries (Rosenthal 1984).

There are many different kinds of managerial behaviors in IGM. Early in the development of US policy implementation research the game was known as dealing with grants and regulations, along with “bargaining and negotiation” over some questions in order to make programs work (e.g., Williams 1980; Ingram 1977; Pressman 1975). Later in the research stream, it was discovered that many, many transactions occur along the line that require cooperation (Elmore 1987), as in the earlier example of Title III of the Older Americans Act. Indeed, IGM has become a pervasive policy activity that can be the entire job of some “boundary spanners” in federal and state government and can consume up to 20 percent of the time of city government managers (Agranoff and McGuire 2003).

Empirical examination of IGM activities reveals that they are considerably more involved than earlier studies suggested. Figure 10.2, taken from the Agranoff and McGuire (2003) study of city economic development cooperation, lists 21 distinct IGM actions. They are both vertical, that is those devices used for working with state and federal governmental officials, and horizontal, working with other local governments, NGOs, and the private sector. The vertical IGM instruments are of two types, those that try to make some form of adjustment to the system within the boundaries of the policy intent of programs and those designed to determine information or joint understandings. The horizontal instruments either serve particular investment projects or help develop or maintain networks of officials. The frequency of these actions is reported in the full study (pp. 108, 113). For present purposes, it is important to note that although with great variation all 21 actions are regular instruments used by managers.

Type of Practice	Use in IGM	Purposes of Practice
Discretion-seeking (Vertical)	Requesting and granting local “asymmetrical” treatment not technically or apparently within standards or regulations.	Waivers Model program efforts Policy changes Funding innovation Negotiated flexibility Trading compliance for performance results
Information-seeking (Vertical)	Seeking and providing program details and/or reaching operating understandings regarding program operations.	Seek program availability and eligibility Seek program operation information Seek interpretation of standards Seek new funding Seek technical assistance
Project-based (Horizontal)	Leverage and engagement of public and private resources to accomplish plans, projects, and other efforts.	Develop managerial partnerships in projects Seek financial resources from partners Combine or leverage financial resources Build financial partnerships for projects
Structural design (Horizontal)	Development and maintenance of organizations or networks for program design and implementation	Engage in joint policy-making Seek policy-making assistance Consolidate policy effort Contracted planning or implementation Employ joint financial incentives Access technical resources

Figure 10.2 Intergovernmental management practices

1. DIRECT PROVISION	2. EXHORTATION/ PROMOTION	3. ORDERS/USE OF GOVERNANCE	4. DIRECT OR INDIRECT SUBSIDY	5. ENDOGENOUS/GROW FROM WITHIN
<p>Improve water systems</p> <p>Improve traffic circulation, streets</p> <p>Improve sewage systems</p> <p>Improve-expand recreation facilities</p> <p>Aesthetic improvements</p> <p>Improve street cleaning-garbage</p> <p>Improve-expand parking</p> <p>Improve public safety services</p> <p>Improve pedestrian amenities</p> <p>Acquire land</p> <p>Clear land of unusable structures</p> <p>Consolidate lot to create large sites</p>	<p>Visit existing business</p> <p>Develop promotional material</p> <p>Visit prospects</p> <p>Attend conferences</p> <p>Use community resource databases</p> <p>Develop business roundtable</p> <p>Use direct mail</p> <p>Participate in trade shows</p> <p>Advertise in media</p> <p>Send videos to prospects</p> <p>Host special events</p> <p>Give achievement awards</p> <p>Executive mentoring</p>	<p>Adopt sign/façade control regs</p> <p>Improve building inspection process</p> <p>Modify the zoning process</p> <p>Consolidate permit issuance</p> <p>Adopt historic district regs</p> <p>Use ombudsman to resolve problems</p> <p>Adopt anti-litter regs-programs</p> <p>Condemn land</p> <p>Relax environmental regs/procedures</p>	<p>Abate taxes</p> <p>Provide tax increment financing</p> <p>Sell land to developer</p> <p>Issue bonds for private development</p> <p>Offer direct loans to private businesses</p> <p>Provide in-kind services</p> <p>Provide grants</p> <p>Contribute cash to projects</p> <p>Offer historic preservation incentives</p> <p>Subsidize loans</p> <p>Donate land to developers</p> <p>Guarantee loans</p> <p>Donate unused real property</p> <p>Relocate business from redev. areas</p> <p>Credit taxes</p> <p>Reduce utility rates</p> <p>Relocate new businesses</p>	<p>Rehabilitate buildings</p> <p>Employee training-retraining</p> <p>Technical assistance to management</p> <p>Share equity in projects</p> <p>Business incubator</p> <p>Manage industrial property</p> <p>Sale-lease back</p> <p>Develop export markets</p> <p>Trade missions</p>

Figure 10.3 Sixty-three economic development policy/program tools

These instruments are used to coordinate programs, that is to help make policy work within a given situation. Following the example of economic development, the Agranoff and McGuire research tested the use of some 61 policy tools. These are potential actions normally authorized by state governments in the US. Depending on the state, city governments have the *option* of enacting by council ordinance, these instruments to promote their local economies. They are listed by category in Figure 10.3. Some involve direct provision of city services, some are merely promotional (exhortation), some involve the direct use of a city's governance power (order), others involve various forms of government subsidy, and others involve different kinds of government investment in the long-term future of the city (endogenous). Again, the use and frequency of engaging such policy tools varies considerably from city to city and time to time (pp. 134–9). They illustrate the “over what” the horizontal and vertical intergovernmental instruments like program waivers or joint planning listed above are transacted. While these tools are particular to economic development, each policy arena would have its own set of program or policy tools that form the means of IGM transaction between governments.

The use of each of these tools normally entails quite involved cooperative managerial processes of an intergovernmental nature. To illustrate the process we will look at how a city might employ just one of these tools, the provision of tax increment financing or TIF. Widely authorized by US state governments, TIF allows a city to designate all of the anticipated increased property tax revenue that will result from a development project to secure tax increment bonds that will finance such elements of a project as land acquisition, property rehabilitation, road improvements, building construction, sewerage expansion and other capital improvements. Cities create TIF districts in “blighted” areas and, after a baseline assessment, hold the valuation constant and use the incremented value to retire the bonds, usually over a 20-year period (Eisinger 1988; Johnson 1999; Weber 2003). A TIF district assures private investors that their property taxes are used to pay for project infrastructure needs, and allow municipalities to circumvent tax limitations (the TIF district is formally outside of city “jurisdiction”) and sometimes voter approval of capital expenditures (Man 1999).

Figure 10.4 lists a possible 17 step sequence, derived from the TIF literature, that a typical city would go through. Its principal managerial contacts include the private developers, the newly created “redevelopment authority,” state government (department of revenue and department of development, attorney general), other local jurisdictions (county, school district, special authorities), a tax valuation contractor, a financial advisor or consultant (to enter the bond market), various contractors who will do the site improvements, and “redevelopment” district bond holders. These contacts, as the figure indicates, require sequenced and overlapping transactional

moves, engendering the cooperation of several entities. These transactions involve a *single* economic development tool. Many jurisdictions, as will be demonstrated, employ multiple approaches.

1. Discussions with prospective businesses regarding site acquisition, site improvements: sewers, water, road improvements, rail road connection, sidewalks, curbs, gutters, parking lot(s), and access roads to nearby highways. Explanation of TIF process, prospective costs and legal requirements.
2. City planning department drafts a redevelopment plan for designated "blighted area," including boundaries and list of hoped for physical improvements.
3. District boundaries/plan approved by city council. Special tax increment district created.
4. Creation of the TIF district to freeze potential increases in property taxes from all local taxing sources to retire debt on capital improvements. Normally by creation of redevelopment authority that is quasi-independent of the city government.
5. City planning department/redevelopment authority, in consultation with developers and city attorney, write an eligibility study, to demonstrate area meets the state legal definition of blight, documenting condition of buildings, zoning and land use regulations, property values.
6. Advancement of eligibility study to the state. State government certification that development would not occur without incentives and that other sources of financing are not available.
7. State designates area as a TIF district for a period of time, usually 20 years.
8. Informal or formal (some states require approval) review with other local jurisdictions (counties, school districts, other special authorities) whose property tax increases will be frozen for the TIF period. Note: Some states also supplement tax losses for education.
9. Base year valuation assessment that constitutes the "freeze" level of taxes for other units. Normally conducted by an outside contractor.
10. The municipality uses its TIF powers to hold constant property tax collections for the designated period. Tax increments are diverted to the redevelopment authority to finance the debt accumulated for the improvements. It uses its eminent domain power to make the improvements.
11. The municipality authorizes the redevelopment authority to issue tax increment bonds instead of general obligation bonds to circumvent debt limitations imposed by state government and in some states required voter approval.
12. Consultations with financial advisors. Valuation data advanced to commercial credit rating agency or private bond firm.
13. The redevelopment authority enters the municipal bond market to generate funds for capital expenditures by selling debt.
14. The improvements are contracted and completed.
15. Pay back either by "front funding" i.e. tax revenues above the level of the frozen assessment that come in over time are used to retire the debt or "pay-as-you-go" where the developer pays first with annual paybacks from the incremental revenue.
16. Periodic consultations with state officials regarding allowable additional improvements in the TIF district.
17. Periodic consultations with overlapping tax jurisdictions regarding fiscal impacts of the freeze and possible <i>prorata</i> sharing of increments, particularly as TIF revenues inflate over time.

**Figure 10.4** Sequence of cooperative actions in a tax increment financing project  
*Sources:* Peter K. Eisinger, *The Rise of the Entrepreneurial State* (Madison, WI: U. of Wisconsin Press, 1988); Craig L. Johnson, "Tax Increment Debt Finance," *Public Budgeting and Finance* (Spring, 1999): 47–65; Jeffrey Luke *et al.* *Managing Economic Development* (San Francisco: Jossey-Bass, 1988); Joyce Y. Man, "Fiscal Pressure, Tax Competition, and the Adoption of Tax Increment Financing," *Urban Studies* 36 (7, 1999): 1151–67; Rachael Weber, "Tax Incremental Financing in Theory and Practice," in Sammis B. White, Richard D. Bingham, and Edward W. Hill (eds) *Financing Economic Development in the 21<sup>st</sup> Century* (Armonk, NY: M.E. Sharpe, 2003).

## **Packaging programs: managing for place**

The real world complexity of intergovernmental programming is such that rarely does a policy effort hinge on a single program like the TIF. Most efforts, at least from the perspective of the local government, invoke anywhere from a handful of programs to a complex array of strategic perspectives. Such is the nature of packaging several intergovernmental programs or what is sometimes called managing from the perspective of jurisdiction or place (Agranoff and McGuire 2003; Elazar 1994b).

This process of jurisdiction-based management can be illustrated by looking at a single project effort of a city government. Table 10.2 highlights the major elements of Salem, Indiana's (population 5,000) efforts in the 1990s to expand the capacity of its industrial park. The city had two firm commitments from existing industries to expand and another new business was ready to relocate in Salem if the "package" was attractive. This would also create two vacancies in the old facility. A total of 210 new jobs were immediately at stake, with potentially more down the road. The city and the local public-private economic development corporation, Washington County Economic Growth Partnership (WCEGP), worked together to put together the eight point strategy, along with three other long-term developments.

The rather integrated strategy accounted for in Table 10.2 demonstrates several important aspects of intergovernmental policy cooperation. First, it is clear that each major step in developing a project entails a different federal or federal-state program, and in the case of economic development the private sector as well. In many cases it involves more than one program. Second, most efforts require lots of sign-offs, approvals and agreements on behalf of several parties. These agreements are both public and private, and normally entail more than one level of government. Third, each subaction appears to involve both an approval and a funding or funding commitment process. Agreement to act is usually followed by subsequent allocation of funds somewhere down the line. Fourth, seldom does an activity involve a single authorization program stream. Most involve multiple streams, for example there are four programs in the business attraction package (including TIF) and three water development loan funding targets. Fifth, reciprocal or complimentary action is usually required, as in the case of the highway 60–20–15–5 percent funding (by the federal, state, county and city respectively) project and its funding. Failure on the part of any party to act favorably effectively eliminates that aspect of the overall effort. And sixth, because the project effort "hinges" on attracting one new and expanding two existing businesses, success depends on virtually all of the package. To lose a major component, e.g., the truck bypass or a key element of the business attraction package could easily cause the withdrawal of one or more of the business commitments.

**Table 10.2** Salem, Indiana’s industrial park expansion project

Project component	Needed action	Agreement/Approval					Funding Source/Obligation				
		Federal	State	City	Other Local	Private	Federal	State	City	Other Local	Private
1. Land Purchase	Find parcel			X	X	X	X	X	X	X	X
	Raise funds – US, EDA grant			X	X	X	X			X	X
	Rezoning			X							
	Contract – WEGP					X			X	X	X
2. Land Improvement/ Site Preparation	City appropriation			X	X				X	X	
	County ED Income Tax				X					X	
3. Building Construction	“Build Indiana” (Lottery fund) program		X					X			
	Fed-State, Small Cities Community Development Bloc Grant		X						X		
4. Business Attraction Packages	Tax Increment Financing		X	X	X				X	X	
	Indiana Industrial Bonds		X	X	X			X			
	8 year Tax Abatement (forgiveness)		X	X					X		
	Streamlined Permitting		X	X							
5. Water/Infrastructure Development	Increase water treatment capacity	X					X		X		X
	US Dept. of Agriculture Loan										
	US Housing and Urban Development Loan	X					X		X		X
	US EPA Loan	X					X		X		X
6. Human Resource Development	US Dept. of Labor-Workforce Development	X			X		X				
	Kentuckiana Community College				X					X	



**Table 10.2** Salem, Indiana's industrial park expansion project – *continued*

Project component	Needed action	Agreement/Approval					Funding Source/Obligation				
		Federal	State	City	Other Local	Private	Federal	State	City	Other Local	Private
7. Truck Bypass of City Center	Obtain Federal (60) and State (25) Privatization and Authorization; County (15) and city (5) "match"	X	X	X	X		X	X	X	X	
8. Park Operation	Extension of contract with Local Development Corporation			X	X	X			X	X	X
9. Business Attraction (future)	US Small Business Administration Loans with state and private venture capital match	X	X			X	X	X			X
10. Housing Development (middle income homes) (future)	US Dept. of Agriculture Home Loans	X			X		X				X
	US HUD – Senior Housing Construction (to free up existing homes)	X	X			X	X	X			X
	Indiana Housing Authority (Low income)			X		X		X			X
11. Computer and Technical Literacy (future)	Adult Education programs, US D of E Special Grant	X	X			X	X	X			X

To the experienced manager, the Salem example is no doubt a simplified overview of a real world project effort. Many missing elements, such as local street building, utilities hookups, environmental permitting, relocation costs and projects, workforce recruitment, noise regulation, increased police and fire services, and increased primary and secondary education implications have been overlooked. Each of these involves extensive leveraging after hundreds of consultations and some follow similar approval and funding processes. It is a real exercise in network management (Agranoff 2003c). Packaging of this nature becomes daunting intergovernmental effort in achieving cooperation that challenges the most experienced public manager. Clearly, not every city becomes so intensively involved, but in order to manage for "the jurisdiction" today, such placed-based management of programs becomes an increasingly important aspect of the intergovernmental cooperation process.

### Interlocal relations: horizontal service and policy networks

Somewhat forgotten in the literature on IGR/IGM are local to local contacts among neighboring municipalities and with other units of local government. Germany, for example, has *geminden* (cities), *kreis* (counties), *samtge-meinden* (amalgamated service districts) and in the Länder states *regierung-sbezirke* (federal land administrative districts). Traditionally, Italy has been organized by villages and municipalities, *comensorios* (sub-region economic development planning bodies), and *consorzi* (service districts). Although Canadian provinces differ somewhat, they are normally organized into counties, cities and towns, villages and townships, and in some large cities metropolitan authorities (Chandler 1993). Spain's pattern of local government also varies by autonomous community, but they are divided into provinces and municipalities, and in many cases also with *comarcas* (service/planning districts) and *mancomunidades* (special purpose authorities). In larger cities there also can be submunicipal *barrios*, and in metropolitan areas, metropolitan authorities (Carillo 1997). The United States is perhaps the most differentiated within states: counties, municipalities, villages, special purpose districts, metropolitan districts, sub-state planning and service regions, and townships.

The challenges of interlocal coordination for both service delivery and policy were initially raised in the illustration of Salem's attempt to expand its industrial park and in the case example of a municipality creating a tax increment financing district. A study of Spanish intergovernmental service production and provision in the Valencia autonomous community (Bañón y Carillo 1992) demonstrates multiple services complexity in cooperation. A total of 42 different types of services were examined from the perspective of the 721 cities in the region. These interlocal contacts included coordinated activity with the government in Madrid, regional government,

provincial governments, special authorities and neighboring municipalities. Although horizontal municipal service-delivery contacts were indicated for some 32 of these different services, they were most numerous with regard to seven functions: fire protection, urban access roads, refuse disposal, solid waste treatment, cultural activities, sports activities, and social services. It is also interesting to note that with regard to two of these seven and for six additional services, there was also notable contracting for services with the private sector (FEMP 1992).

More is known regarding cooperative activity in the United States. Although the data is dated, about half of all cities (52 percent) and counties (54 percent) reported entering into intergovernmental service contracts. The ten most frequently purchased services by intergovernmental contract were for: jails/detention homes, sewerage disposal, tax assessing, animal control, water supply, solid waste disposal, police/fire communications, tax utility bill processing, traffic signal installation/maintenance, and sanitary inspection. Fifty-five percent of cities (60 percent) and counties (54 percent) entered into joint service agreements with other governments. The most frequent city provided services by joint arrangement include: police/fire communications, libraries, sewage disposal, fire prevention/suppression, jails/detention homes, solid waste disposal, emerging medical/ambulance, animal control, recreation facilities, and water supply (Henderson 1984). More recent research that is less detailed in nature reveals similar levels of contracting and service agreements (Shanahan 1991; Ross and Levine 2001: Ch. 8).

The other face of interlocal collaboration is that of policy networks involving various jurisdictions of local government and non-government organizations. Again, the unfolding of Salem's industrial park expansion interlocally came through activating its local policy networks. As Hanf (1978: 1) explains, "Territorial and functional differentiation has produced decision systems in which the problem solving capacity of governments is disaggregated into a collection of sub-systems with limited tasks, competencies and resources, where the relatively independent participants possess different bits of information, represent different interests, and pursue separate, potentially conflicting courses of action." The interlocal process "connects public policies with their strategic and institutionalized context: the network of public, semi-public and private actors participating in certain fields" (Kickert and Koppenjan 1997: 1). At the interlocal and other levels, "Networks facilitate interaction, decision-making, cooperation and learning, since they provide the resources to support these activities, such as recognizable interaction patterns, common rules and organizational forms, and sometimes even a common language" (Klijn 2003: 32). In short, interlocal and other networks refers to "multiorganizational arrangements for solving problems that cannot be achieved, or achieved easily, by single organizations" (Agranoff and McGuire 2001: 296).

These multi-organizational interdependencies have been a part of the policy network literature from the early days of implementation research. For example, Hanf *et al.*'s (1978: 332) study of local manpower networks in Sweden and West Germany – planning, resource mobilization, and execution – cites the differentiation of multi-actor roles, the need for larger amounts of information exchange and the absence of any form of evaluating performance. Many of these themes pervade more recent research (Radin *et al.* 1996; Radin 2000; Bardach 1998). More recent studies of local policy networks suggest that their structure and operation is more complex and difficult to characterize easily, with greater concerns for their ability to link up with citizen engagement (Niemi-Iilahti 2003), the impact of power and jurisdiction/organization strength on network process (Webster 2003), and the degree to which the use of networks diminish governmental jurisdiction (Agranoff 2003c; Frederickson 1999).

What does this involved routine behavior mean for the understanding of federal intergovernmental policy cooperation? First, it is clear that managers at the local level, where programs meet people, participate in national and state programs but try to fit them into the needs and expectations of the local community. That is why they seek expanded information and discretion channels. Interactions over the policy tools, for example, are designed to meet both higher policy aims *and* jurisdiction needs. This often involves some degree of consultation and negotiation, that is federal cooperation.

As a result of the dual federal-local interests a second implication is the need for communication/transaction channels between levels of government. These routines of policy cooperation come primarily through telephone, email, face-to-face, or written communications and sometimes through more formal application procedures. The important issue is lines of contact be maintained and utilized, a skill that many experienced public managers learn over a period of time (McGuire 2003).

A third issue is that the vertical interactions identified are normally based on a set of horizontal interactions within the community, an overlapping set of cooperative actions. In economic development, most city transactions regarding economic development policy tools come as a result of a networked process among business or potential businesses, other local governments, community groups, and various NGOs like Chambers of Commerce or local economic development corporations. Working with the city they develop agendas that have the policy adjustment implications that ultimately “go up” the vertical IGM line (Agranoff and McGuire 1998).

Since these agendas are not always over a single program or policy a fourth issue is that intergovernmental programs must often be “packaged” into a coherent set of cooperative and interactive adjustments that serves a community’s need. This phenomenon of “packaging” was illustrated in terms of one small city’s process of expanding its industrial park. It

demonstrates how several programs can be intergovernmentally adjusted, with a great deal of cooperation, for some broader purpose.

A fifth and final finding with regard to IGM is that while an increasing number of local managers appear to be playing these games, not all do. While the opportunity is there for every city to become heavily engaged in IGM, the economic development study revealed that a notable number of cities do not. Some do not extensively engage the policy system because they do not have the knowledge or skill, or that other, internal priorities take precedence. Others face internal opposition. In regard to economic development, some cities may be in an economic position so that they do not need to work hard to promote their economies. They may be inactive in this arena but more active in other areas (Agranoff and McGuire 2003: Ch. 3). Whatever the circumstances, it is a cooperative game that everyone can play, but clearly everyone does not.

### **Conclusion: uncovering the fourth pillar of power**

The depiction of IGR/IGM within the policy process appears to be reciprocally involved and protracted. They are, indeed, deeply complicated governmental processes. The need for such policy cooperation may not be as entangled everywhere as it is in the United States, but there is increasing evidence that as many more entities have a stake and a role in policy process the cooperative process becomes near universal. In both federative (Radin *et al.* 1996; Jeffery 1999; Galligan 1995; Walker 2000) and unitary countries, particularly those where devolution and autonomy have become part of the federalist movement (Agranoff 2004; Armstrong and Dekervenoael 2000; Rhodes 1997; Rose 1984) there is greater interest in IGR/IGM.

Which federalism do these protracted and involved processes involve? All federal arrangements appear to bring on these measures of intergovernmental policy management in some measure, whether it be executive federalism negotiations or the central-regional-local details in policy areas like economic development financing. It is probably safer to conclude that the evidence is more forthcoming from the US than from other systems, because it is more extensively studied, not because the different forms of cooperation are non-existent elsewhere. Federal arrangements are by their nature non-prefectural, jurisdictionally autonomous, and open to discussion and negotiation. That is why 27 generic IGR arrangements can be identified, over 20 IGM tools uncovered, not to speak of the myriad practices of forging linkages identified in this chapter.

Federal cooperation means there is a lot more than meets the eye when one looks beneath the surface. The overlay, that is the network of agreements, are needed to meet the ethnic, economic, global, and devolutionary challenges of contemporary (some say post-modern) federalism. To considerable extent, which federalism means which arrangements within the

matrix of cooperative arrangements are being used to serve which policy and program needs? As the state becomes more differentiated and matrixed, as increasing demands for more federal-like arrangements accelerate, the need for cooperation through intergovernmental policy management will correspondingly become apparent.

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## **Part IV**

### **Conclusion**



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# Conclusion

What changes are necessary in the policy and institutional spheres for a political system to be characterized as a federal system?

The concluding chapter is highly comparative in nature and it looks at how the European Union, as an example of a “composite” form of federalism, has evolved in response to the challenges of globalization and the need of nation-states in Europe and elsewhere to respond to an increasingly differentiated set of demands concerning economic growth, democratization, and reformed welfare state systems. The systemic responses are then used to analyze economic and social policies and the methods used to govern these areas. With regard to the European Union the argument is made that in terms of economic policy regarding the single market, the single currency, cohesion policy, external trade and competition the mode selected to manage the policy is a quasi-federal one while in relation to social policy – training, education, health, and pensions – the approach is much more intergovernmental in nature. The question raised is whether these forms of policy governance structures are stable over time or whether they tend to change in response to: (1) changes in the treaties empowering the EU to assume policy initiatives; (2) the challenges emerging from the global system, and (3) the nature of the Union. As has been made evident during the last three enlargements – 1986, 1996 and 2004 –, the entry of new member states has the effect of widening the policy areas necessary to be addressed by the EU rather than watering down the commitments and activities of the Commission and the Council of Ministers. Therefore, an interesting interaction has been created by the intergovernmental and communitarian approaches to policy-making that has led over time for policies to shift from intergovernmental to communitarian and for the communitarian policies to assume federalist characteristics.

# 11

## Thinking About Federal Systems in the 21<sup>st</sup> Century in Light of the European Experience with “Operational” Federalism

*Robert Leonardi and Raffaella Y. Nanetti*

### I. Overview

The volume has presented ten chapters divided into four parts looking at different aspects of the dynamics of federalist systems over time. Part IV is represented by this concluding chapter which looks at the recent European experience and how it has changed at the supranational level. We will not discuss what has happened within nation-states because that has, in part, been covered by Agranoff, Chapter 10. Before drawing the lessons from the ten chapters presented above, we need to review the major categories covered by the volume: the constitutional and political framework, the fiscal framework and the policy framework of federalist systems. All of the authors have tried to go beyond a limited reflection on only the North American experience and have focused on the broader global experience with federalist systems and how they have changed in reaction to socioeconomic challenges. The volume begins with the observation that federalism does not only exist in North America; it is present in political systems around the world, such as Brazil, Argentina, Mexico, Australia, India, Nigeria, Germany and Switzerland. Therefore, we need to look at the concept and practice of federalism on a comparative basis across space and across time. One of the main theses of this volume has been that federalist systems by their very “composite” and “inductive” natures need to be studied over time. For us federal systems are composite political systems because they tend to vary from one political system to another and there is no one model of federalism that is predominant over others. Second, federal systems are inductive in nature in that they are the result of a series of compromises that have been made in bringing together pre-existing political structures. This characteristic is evident in the major examples – i.e., US, Canada, Brazil, Australia and the EU – that are discussed in this volume. In other words, federal systems usually develop as an answer to: how to coordinate or merge pre-

existing political institutions into a new system of governance or how to manage the transition to democracy from imperial rule (e.g., US, Canada and Australia) or from dictatorial centralized rule (e.g., Germany and Austria but also Spain and Italy from the point of view of extensive regional autonomies). Therefore, it is rare for new political systems to be given a federal nature given that federalism is based on a pre-existing ability of the component elements of a federal system to initially govern themselves and then to cooperate with other existing sub-federal political systems. The composite and inductive nature of federal systems represent important elements in the discussion of the first part in the volume dealing with the constitutional and political framework of federal systems.

The first part contains three chapters by Filippo Sabetti, Susan Clarke and Ann Bowman, and in the introduction to the section, Celina Souza points out that the three chapters identify the key features of federal systems, the role of geographical space in delimiting the reach of governments, and the complexity in governance and the participation of citizens in federal political systems. The important question here is why do federal systems come into existence and how do they differ from other representative systems of government in responding to the challenges of globalization and to the changing exigencies of international and national political systems?

As highlighted by Michael Pagano in his introduction to the second part, the chapters by Jeffrey Chapman, Christopher Hoene, and W. Bartley Hildreth examine the shifting economic and tax systems of federal systems, with particular attention on the role of transfers, redistribution, and local (own-source) revenue structures. It is argued by Pagano that polities survive to the extent that their revenue-raising authority is efficient, adequate and equitable. In other words, federal systems survive if they are in a position to function well from a fiscal perspective. The issue of how well federal systems are in a position to deliver services to their citizens in an effective and efficient manner is covered by the third set of chapters.

The third part – consisting of the three chapters by Carol Weissert, Daphne Kenyon and Robert Agranoff with an introduction by Sarah Liebschutz – looks at how service delivery is organized in federal systems by beginning with an historical analysis of the US case between 1789 and 2006. It proceeds to look at how federal systems, in general, are in a position to guarantee an efficient and equitable distribution of service delivery. Finally, the part presents an analysis of how federal systems deal with the increasingly intergovernmental aspect of managing service definition and service delivery in complex and large political aggregations.

The purpose of the concluding chapter is not to reanalyze what has already been said in the ten previous chapters but rather to use the contents of the chapters as a jumping off point to look at the state of federalism in the 21<sup>st</sup> century in light of the experience of the European

Union with “operational federalism” – i.e., federalism in substance but not in name. The question is relevant because federalism, as has been argued in the volume by a variety of authors, needs to be conceived as a fluid concept that has manifested a number of phases, evolutions, and idiosyncrasies during particular historical periods and in different geographical areas of the globe. Given that studies of federalism tend to be more case study rather than comparative in nature, it is at times difficult to categorize how different federal systems have changed or evolved over time.<sup>1</sup> Bakvis and Chandler (1987: 8) argue that “Answers provided through comparative analysis, while rarely definitive, are nonetheless valuable either because they indicate that certain practices or outcomes constitute universal patterns or because they reflect conditions within one system that are in fact unique.” Therefore, what we are interested in is the potential universal patterns to be discerned in looking at how federalism is operationalized in different political, geographic and historical contexts and what it tells us about decision-making and implementation in different political systems.

But there is also another variation of federalism that needs to be attentively studied – that is, the change in the content and function of federal systems over time. Such a longitudinal analysis have been carried out by Bowman and Sabetti. Ann Bowman has undertaken an across time analysis for the volume on the case of US federalism. On the other hand, Filippo Sabetti looks at how Canadian federalism has changed over the last century and provides an extensive analysis of what federalism meant for European intellectuals during the 19<sup>th</sup> century. What these two chapters show is that we lack a clear notion of when a system is or becomes federal in its operationalization – that is, in carrying out the tasks of decision-making and policy implementation – and when it is not. The lack of a clear understanding of how federalist structures evolve and develop over time in relation to internal and external challenges makes it difficult to assess what is currently taking place in different parts of the world where the traditional nation-state has entered into a period of transformation and new decision-making and implementation structures are emerging. The questions that need to be asked on the basis of these premises are:

- Is federalism evolving and assuming different characteristics in different geographical contexts as part of globalization?
- Is federalism, as an institutional/political concept, on the rise or is it slowly withering away?
- Does the United States still represent the ideal model or has the impact of globalization and the different needs placed on political systems in the modern age lead to the emergence of new ideal forms of federalism?
- Can the concept of governance help us understand the changes that have taken place in federalism?

- Does the concept of multi-level governance reflect the nature of federalism? Is multi-level governance federalism with another name or is it something else?

We have conceived our task as one not engaging in futurology or trying to predict what will take place during the course of the 21<sup>st</sup> century. Instead, the objective of this chapter is linked to an understanding of when is a political system federal, what are the necessary component elements of federalism, and how does federalism change over time and space? In many cases, innovations in federal structures or behavior tend to be ignored or interpreted as an idiosyncratic form of the traditional model rather than an adaptation to new exigencies which could not be incorporated in the old model.

In the case of federalism, the United States has often been used as an operationalization of the federal model. As a consequence, if a political system is not similar in its constitutional structure to the United States, then it is not deemed to be federal in nature. Or even worse, if a country does not label itself as federal, then it is not classified as federal. In other words, federalism is treated as a formalistic definition that political systems attribute to themselves rather than the result of an independent analysis that is based on how political systems carry out economic and social policy within the context of multi-layered government.

## II. Federalism in the 21<sup>st</sup> century

To understand what federalism is or how it is changing in the 21<sup>st</sup> century we need to develop a conceptual framework that goes beyond how political systems define themselves and that is capable of objectively analyzing what political systems do. The problem of defining what is federalism has already surfaced in a number of contributions to this volume especially by Filippo Sabetti and Ann Bowman, in relation to Canada and the Commonwealth countries in general – e.g., Australia, New Zealand, India and South Africa – but also in relation to the changing nature of economic and political interactions within the United States. The analyses have shown that countries may be created as unified states and can, over time, evolve in a federalist direction. This is the case with Canada and with a number of nation-states in Latin America. In Europe we have seen the same phenomenon: nation-states evolve over time in relation to internal and external challenges. The best examples of such evolution is Belgium which over 20 years, starting in 1970, evolved from being a centralized Napoleonic state to a federal one. Similar changes – though not as extensive – have taken place in Italy, Spain and France in their evolution from a centralized state structure to a regional one based on a significant differentiation of powers between the national and regional levels.

There are also examples of nation-states creating a “partially federal” system in relation to some regions and not all of the regions of a country. This type of “asymmetrical” regionalization has taken place in Portugal in 1976 with regard to the ultra-peripheral islands of Madeira and the Azores and in the UK in 1997 in the cases of Scotland and Wales (Bulmer *et al.* 2002). The question that persists in the analysis of subnational governmental structures in Europe is, what are the main differences between federal and regional structures from a policy-making and implementation perspective?

From an operational point of view in terms of what and how subnational governmental levels do, there is little difference. In both systems there is a separation of power in policy areas but in both cases there is a practical need to coordinate national and subnational interventions in order to maximize outputs, and in both cases there is the need to create formal as well as informal institutions linking the two levels of government.

In both federal and regional systems taxing powers are shared between the two levels of government. In federal systems the subnational units are able to define in an autonomous manner the nature and extent of taxation – i.e., determine by themselves who, what and how to tax. In regionalist systems that power is reserved to the national level. It defines what can be taxed and to what extent, even though the actual tax is collected and used by the subnational governmental units.

Representation of territorial units at the national level is another element that is resolved differently in federal *vis-à-vis* regional systems. Federal systems are based on a more explicit representation of the country’s component political units at the federal level. In the case of the United States this function is fulfilled by the Senate and in Germany it is carried out by the Bundesrat in a differentiated manner. In the case of the US the representatives of the states are directly elected by the people while in Germany they are appointed by the Länder government.

In a regionalized system the region is not formally represented at the national level. In these cases the electoral district for the senate in the three countries are structured at the regional level (Italy) or in the case of France and Spain the representatives of the regions are given a consultative and not a deliberative role in policy-making. Therefore, what mostly distinguishes regional from federal systems from the perspective of representation is the explicit decision-making role allocated to one of the two representative chambers at the suprastate level in federal systems.

In all three regionalist cases in Europe the debate on federalism – i.e., how to move the institutional structure from a regionalist to a federal system – has focused on two of the aspects discussed above: the change in how the regions are represented and given deliberative powers at the national level and the autonomous nature of taxation. Within these three countries the switch from a regionalist to a federalist “definition” of the political system is

based on the structure of political representation at the national level and the attribution of direct taxing powers to subnational units.

Other policy areas tend to differ from one federal system to another. In the case of Germany the Länder have powers over the local banking system. This is not the case in the US. There is little difference in relation to education between regionalist Spain and federal US. In both cases the subnational units have power over significant aspects of the higher and secondary education systems in creating educational units and determining part of the curriculum. In other policy areas there is a mix of responsibilities between national and subnational systems and therefore a lack of uniform differentiation between federal and regional systems. The differences are most pronounced between European and non-European economic and social welfare policy packages and the role that subnational units play in the delivery of social and welfare services.

Up until now the discussion of the nature and structure of federalist and regionalist state structures has been conducted on the basis of two levels: national and subnational. What we have seen in Europe during the last five decades has been the creation of **supranational** institutions which has not been clearly the case elsewhere. The question here is how does the creation of third level of government in the European context fit into the discussion of traditional forms of federalism? How does the creation of a tri-level system of control over policy-making change our conceptions of how centralized, regional and federal states operate? To answer these questions we need to return to the fundamental notions of federalism.

We have to begin with the preliminary question of "what is federalism?" If we accept Clint Bolick's (1994) definition of federalism as: "a constitutional structure by which government powers are diffused and dispersed as far as is consistent with effective government and the preservation of fundamental individual liberties" it is difficult to deny that the diffusion and dispersion of governmental powers have become a general phenomenon in both federal, regional and centralized state structures. As has been argued by Filippo Sabetti in Chapter 2, decentralization is a world-wide characteristic of political systems in the modern age as central governments find themselves in an increasingly difficult position to respond to challenges of globalization in the political, economic, social and cultural fields originating either from within or outside of national systems. This is the case in Europe but also in other parts of the world such as Latin America, Africa and Asia.

The diffusion of governmental powers and the differentiation of exigencies placed on governments have pushed a number of scholars of federalism to use the concept of "governance" as a more appropriate basis for analyzing what governments do and how they carry out their functions. Defining governance as "the interaction between political institutions and civil society in the management of formal public policies" (Leonardi 2005:



13) the emphasis is placed on the interaction between formal institutions and informal procedures and role played by organized groups in producing the policy outputs desired. Borrowing from Susan Clarke's approach to governance presented in Chapter 3, it is clear that globalization and the numerous challenges to the modern state require the development of new governance mechanisms in the political, economic and social spheres. Thus, we would argue that all governments are being challenged from within their political system and from the outside to develop new systems of governance that do not always respect the formal institutional parameters or traditions of a particular nation-state but which are, nevertheless, essential in producing the desired policy outputs.

The development of new procedures and instruments of "political governance" – i.e., the creation of new decision-making and implementation rules and outputs – outside of the national political and constitutional parameters may be necessary for all three types of centralized, regionalist and federal nation-states in order to achieve acceptable levels of management of economic and social policies and security and defense initiatives. We would argue that during the last 15 years, especially after the incorporation of the Single Market and Single Currency programs, the European Union has moved to a state of "operational federalism" in the management of important or functional policy areas, such as cohesion, competition, foreign trade, immigration, internal market, monetary policy, and justice and home affairs. Thus, the governance of "Europeanized" policy areas within the EU may be best analyzed as operational or functional federalism in that it makes more sense to understand the governance process associated with specific policy areas in federalist terms as illustrated by the chapters in Part III of this volume rather than in the traditional unified central or bi-layered federalist approach.

Giuliano Amato (2003: 578) has argued that the European Union "already incorporates principles characteristic of federal systems with the principle of loyal cooperation between states and the supremacy of Community law." The important aspect for Amato is the fact that the federation is in a position to make the component elements work together for the purpose of achieving common objectives based on the conviction that those objectives would not be realizable if member states were to act alone. The question remains whether the European federation as described by Amato necessarily implies the existence of a federal system. Michael Burgess (1986: 17) argues that "the federal principle is, above all, an organising principle, and it follows logically from this that federation is the organisational form which corresponds to this principle." Thus, for a federation to exist it requires "specific structures, institutions and techniques" (Burgess 1986: 17). During the post World War II period European integration evolved as a union of existing nation-states that prior to the war were locked into mortal conflict through the creation of formal institutions (e.g.,

Commission, Council of Ministers, European Parliament, and European Court of Justice) whose functioning are governed by Community law and the binding treaties that have been passed.

Murray Forsyth (1981) has developed a useful definition of “union of states” which is useful to reiterate in our discussion of 21<sup>st</sup>-century federalism. To begin with he describes a union of states as one “that falls short of a complete fusion or incorporation in which one or all the members lose their identity as states.” A second characteristic is that: “it is the union which is specifically ‘federal’ in nature. This means that it is based on a *foedus* or treaty between states, and not on a purely one-sided assertion of will.” For Forsyth federalism is “a type of *government founded upon a foedus or treaty between states*” (Forsyth 1981: 2) and it does not make a difference where the component elements of the federation are, in turn, federal states or states with centralized structures.

Forsyth, for one, would not ask the question of whether it is easier (or is the “fit” better) for federal or regionalist nation-states to make the transition to a European federal structure *vis-à-vis* countries with centralized structures. History has shown that large federal and regionalized states in Europe – Germany, Austria, Belgium, Spain, Italy and France – have been highly receptive to the restructuring of political governance through the creation of new institutions and collective decision-making processes at the European level, but this evolution has also been accepted by centralized states, such as Holland, Finland and Greece.

The debate on “what kind of political system is the European Union?” has a long tradition. From Ernst Haas’ ground breaking *The Uniting of Europe* (1958) to Glyn Morgan’s *The Idea of a European Superstate* (2005), the actual nature of the European Union is contested. The bulk of the academic literature argues that the workings of the European Union suggest that it is not a federalist state in the making but rather an inter-governmental arrangement between sovereign member states who for reasons of efficiency and efficacy have banded together into a regional bloc (Moravcsik 1998; Milward 1992). For Moravcsik, the “EC is a unique, multilevel, transnational political system” (p. 1), but the question asked by federalists is whether it is so unique or is it an example of a federal system in the making (Burgess 1986). Figure 11.1 tries to provide some institutional and policy indications of where the EU might be located in relation to the expectations of the three theoretical approaches to defining and explaining the functioning of the European Union. The first is the intergovernmentalist approach. The second is the neofunctionalist approach first formulated by Ernst Haas which in EU parlance is referred to as the “Community method” as operationalized by Jean Monnet and the fathers of European integration. The third is the alternatives of what would be expected from a federalist approach or what the European Union would look like if it were a federalist system. What we are trying to capture

	FEDERALIST APPROACH	MONNET APPROACH/ NEOFUNCTIONALIST	INTERGOVERNAMENTALIST APPROACH
<b>Logic</b>	Top-down institutional approach	Bottom-up policy approach	Horizontal national approach
<b>Priorities</b>	Political institutions	Economic policies	Maintenance of economic & political <i>status quo</i>
<b>Dynamic</b>	Policies governed by politics	Spillover: broadening of policy reach	Maintaining sectorial autonomy
<b>Single policies</b>			
<b>Single Market</b>	Bringing market consideration within context of federal government	Result of move from freetrade area to customs Union	Remaining at level of freetrade area
<b>Single Currency</b>	Uniform approach to monetary policy and fiscal arrangements	From EMS to EMU	National currencies/Opt-out
<b>Cohesion policy</b>	Pro-active social and economic policy; transfer payments; federal block grants	Restructuring of national and regional economies into single market and single currency; programmatic approach	National control of regional policies Side payments
<b>Competition policy</b>	One supranational approach	One supranational approach	Separate national approaches
<b>Trade Relation</b>	One voice	One voice	Different voices
<b>Agriculture policy</b>	One policy	One policy	Many national policies
<b>Foreign policy</b>	One policy	One policy	Many national policies
<b>Defense policy</b>	One policy	One policy	Many national policies

#### End Result of Different Institutional Approaches

Executive Branch	One executive	MLG provisions	Separate set of institutions
Representative Branch	One representative assembly	Concertation	Separate set of institutions
Judicial Branch	One judicial branch	Balance among branches of govt.	Separate set of laws
Policies	One set of policies	Hierarchy of policies	Separate policies
Laws	One set of laws	Hierarchy of laws	Separate legal systems

Figure 11.1 Theoretical approaches to institution building and policy-making in the EU

in the contents of Figure 11.1 is a means for discussing the implications for institutional and policy-making arrangements of present practices in a variety of policy-making fields.

We will look at these issues with regard to two policy areas – economic and social policies – that illustrate the two distinct patterns of governance: the operational federalism created through the “Community method” where the rules and resources are controlled at the European level and the intergovernmental approach or the “open method of coordination” which has come into vogue as a means of coordinating policies and activities at the supranational level.

### III. Governance of economic policies

It is undoubtedly true that the development of new forms of global and area-wide economic governance have created the greatest pressures on adhering to a new system of policy-making and implementation. At the international level we have the creation of intergovernmental global (e.g., World Bank, IMF, and WTO) and area-wide institutions (e.g., EFTA, OECD, ASEAN, Mercosur) to govern certain aspects of economic transactions. In the case of most nation-states that task is managed through traditional diplomatic procedures, but in the case of the European Union, international trade relations are handled through a supranational governance of the policy. The transfer of the responsibility to manage specific economic sectors from the national to the European level has been part of the “functionalist approach” presented in Figure 11.1 to European integration that was championed by Jean Monnet and opposed by European federalists, such as Altiero Spinelli. The federalist approach emphasized the role of politics over policies and the need by the existing federal institutions to formulate one policy for all of the component elements of the union.<sup>2</sup>

History has shown that this has not been possible within the European confederation of states because institutions have been created and developed at the services of the policies that have been “Communitarianized” or moved to the European level from the national one. The intergovernmental approach cannot provide such an explanation or justification for the process. To understand the differences between what happens within the European Union and other systems for the governance of international trade (or what would happen within the context of a pure intergovernmental or federal approach) we need to distinguish what differentiates customs unions from free trade areas or cases in which nation-states are not engaged in any other form of governance of international trade with other countries.

In Europe, ever since 1948 with the creation of the first Benelux Customs Union bringing together Belgium, Holland and Luxembourg, it was obvious that individual states – given the small size that was usually found in Europe – were not in a position to have a major voice at the world level.

Therefore, when the European Economic Community (EEC) was born in 1958 through the ratification of the Rome Treaty, the primary objective was the creation of a customs union incorporating the three Benelux countries in addition to France, Germany and Italy. The completion of the customs union in 1969 effectively Europeanized the six member states' economic relations with third countries and with international economic bodies. Responsibility for defining the EEC's trade relations with other countries was allocated to the European Commission. As the EEC evolved to the European Community (1986–96) and then into the European Union (1996 onward), the allocation of the governance of economic relations with third countries or with world economic bodies remained in the hands of the Commission.

Similar needs are reflected in other geographic areas of the world, but other regions in the world have not been able to create the policy-making institutions and procedures adopted by the European Union. Others have opted for intermediate solutions between individual national markets and customs union in the direction of free trade areas. Free trade areas help the prospects of freeing the flow of trade among participant countries, but they do not provide an answer to multi-lateral economic governance at the world level – i.e., with third countries outside of the free trade area. This is abundantly clear if we look at what happens within the North American Free Trade Association or other free trade blocks. Free trade agreements concentrate their effort on the opening up of trade through reciprocal national agreements and not through the creation of supranational institutions or policy processes.

In free trade areas individual governments manage their own affairs when it comes to interacting with third countries or the WTO. This fact is illustrated by the Boeing–Airbus controversy or the previous steel disagreement between the US and the Europeans. For the latter, the interlocutor in the controversy is the supranational European Commission while in the latter it is the US government. The other countries in NAFTA (or NAFTA itself) do not have any role in the dispute. A similar example is provided by the textile dispute with China. In the case of the US, it is the federal government that has taken a stand against China on behalf of textile producing states while in the case of Europe it is the Commission that has to assume the initiative on behalf of important textile producing countries such as France and Italy. Thus, with the creation of the customs union in 1969 the countries of Europe began the process of creating a system of governance of economic affairs that we can call operational federalism in the field of economic policies.<sup>3</sup>

Other examples of federalist or multi-level forms of economic governance exist in Europe. The 1958 Rome Treaty that formulated the objective of the customs union also attributed the management of competition and agricultural policy to the Commission. Subsequently, the governance of the

Single Market was attributed to the Commission by the Single European Act in July 1987. The same is true with regard to the allocation of responsibility of cohesion policy by the same treaty. In 1988 the Commission was transferred the governance of the EU's regional development policy by the SEA and the Regulations that governed the operation of the European Regional Development Fund, the Social Fund and the European Guarantee and Guidance Fund-Guidance section. In 1993 monetary policy was Europeanized through the operationalization of European Monetary Union. In this case, a new institution was created, the European Central Bank, to manage the policy. Therefore, through time there has been a gradual accumulation of economic responsibilities at the supranational level that has profoundly changed the way certain economic functions are governed through the creation of new institutions or the attribution to existing supranational institutions new functions.

The economic governance we are referring to is not the governance of economic affairs through the price mechanism in the market. Rather as Susan Clarke has recognized in her chapter, "governance through market strategies can lead to short-term and *ad hoc* responses rather than the long-term strategic guidance necessary when dealing with multiple stakeholders, tangled networks, and the need for negotiated decisions." What we and Clarke refer to when we use the term economic governance is the creation of institutions and formal procedures at the supranational level to govern the European market as defined by the aggregation of a growing number of member states. Institutions in this case are those procedures and enforcement mechanisms put into place by the Rome Treaty (1958), the Customs Union (1969), Single European Act (1986), and the Maastricht Treaty (1993) designed to govern both intra-European as well as extra-European trade and economic considerations. For the other policy areas, some (competition, international trade relations and agriculture) were already brought up to the European level for decision-making through the Rome Treaty. Others (foreign and defence policies) are still awaiting a full form of Europeanization.

How does the functional or operational federalism described above differ from the "type II" multi-level governance described by Hooghe and Marks (2003)? Hooghe and Marks make the distinction between type I and type II multi-level governance systems. Type I is defined as the traditional federalist interaction between federal and state levels in the carrying out, for example, of revenue sharing programs. Type II multi-level governance is described instead as "one in which the number of jurisdictions is potentially vast rather than limited, in which jurisdictions are not aligned on just a few levels but operate at the numerous territorial scales, in which jurisdictions are task-specific rather than general purpose, and where jurisdictions are intended to be flexible rather than durable." The examples of task specific institutions cited by Hooghe and Marks are the San Francisco Bay

Area Rapid Transit Authority, New York Port Authority, Chicago-Gary Airport Authority, etc. where the task is specific and the territory that is managed is clearly delineated.

In contrast, the types of economic governance we have describe above are similarly task specific but they refer to the same territory (i.e., overlapping jurisdictions) and are allocated to the same institution. All of the specific tasks (aside from EMU) that have been transferred from national to European governance procedures have been allocated to the European Commission. Therefore, there has been an accumulation of economic governance tasks by one institution whose powers *vis-à-vis* the Council (representative of the member states) and European Parliament (directly elected by the people) have grown considerably. Second, the tasks that have been Europeanized relate to the same territory – i.e., all of the member states that compose the Union. Finally, in the European Union conflicts between levels of jurisdiction – i.e., member states and Commission – over the governance of the policy are adjudicated by the European Court of Justice and not by national courts. Therefore, if a member state has been found in violation of European law, financial sanctions can be enforced. In free trade areas this type of adjudication of conflicts as well as the relevant institutions are absent.

At the world level a partial form of economic governance is emerging through the activities of the WTO in the field of world trade while other fields of economic governance are allocated to completely different institutions. Therefore, from the perspective of the accumulation of powers in economic governance within a single institution the European Union still remains a unique political and economic construct. However, if we look carefully at what is taking place in the Caribbean and Latin America the impact of the European example may not be so unique. Here too there is an appreciation of the increased economic clout that is possible for small and/or economically weak nation-states to exercise at the world level if they coalesce into customs unions and single currency areas rather than by being stuck at the level of the sovereign nation-state or in free trade areas. In contrast, free trade areas provide a minimal amount of governance mechanisms aside from multi-lateral intergovernmental agreements that cannot be policed or enforced against a country's unilateral action.

In Europe the need to acquire or become a member of the European economic governance process has created a growing number of countries applying to join the European Union. In other words, as soon as political independence or the end of political subordination to a dominant power has been achieved, the next step has been to apply to join the European Union. This was the case for the eight central and eastern European countries that joined in 2004, and it also holds for the two countries that will join in 2007 and the five countries (Turkey, Croatia, Macedonia, Serbia and

Montenegro). It was also the case with Greece, Portugal and Spain: as soon as they emerged from dictatorship they too sought to join the EU.

A similar pattern is being repeated for the other countries along the Russian border that have recently achieved greater political and economic autonomy, such as the Ukraine and Georgia. As long as the precise borders of Europe or limits to the membership in the EU are not established, it is possible for contiguous states to ask for membership. This imperative is also operational in countries that might, from the perspective of cultural heterogeneity and cultural governance, appear to be outside of the European framework. Turkey clearly falls into this category of a country whose cultural makeup is quite distinct from the European one, but in the case of Turkey the cultural and religious factors are trumped by the exigencies of the economic governance imperative.

#### **IV. Governance of social policy**

Social governance is another field that has recently spilled over national borders. In the European context the need to develop and adopt new instruments for social governance is strongly associated with the acceptance in 2000 of the Lisbon Agenda: the goal of transforming Europe into the world's most competitive economy by 2010 (Commission 2004). The strategy devised for achieving this objective has three components. The first is the transition to a knowledge-based economy and society by the formulation of targeted policies to create a robust "information society" and promote investments in research and development. The second component of the strategy focuses on the undertaking of structural reforms in the fields of labour mobility, unemployment policies, and national pension systems to create incentives for workers to remain in the job market (i.e., job retentions) and increasing the percentage of the population entering the job market (i.e., job creation). The third objective is to modernize the European social model by investing heavily in professional training, job placement and combating social exclusion.

The policies that needed to be derived from the first and third objectives were the establishment of an European Area of Research and Innovation, the creation of an environment for new firms in innovative sectors, the completion of the Single Market in those areas not fully incorporated in the initial 1992 reforms, and measures to create a fully integrated European financial market. The Lisbon Agenda also saw an enhanced role for structural policies and a redirection of public expenditure toward increasing the relative importance of capital accumulation and support research and development, innovation and information technologies.

The attempt to revise the European social model represented one of the more ambitious objectives of the Lisbon Strategy. Part of this objective was the attempt to alleviate pressure on labor through tax incentives and



especially on the relatively unskilled and low-paid. In addition, the Strategy foresaw the creation of tax incentives to improve and extend employment and training incentives. Part of these changes affecting the current and future labor force required a change in the relationship between the educational system and the labor market – i.e., market considerations need to be brought into the traditional educational programs or be structured to shorten the transitional period between exit from the educational system and entry into the labor market. An integral element of this strategy requires member states to formulate active employment policies and to restructure social protection to ensure that adequate measures are in place to render employment profitable (i.e., ensure wage levels that generate higher wages than can be gained from social support schemes) and making sure that pension systems are sustainable given the increased aging of the European population. It also defined the overall objective of promoting social inclusion, in particular by improving skills, promoting wider access to knowledge and opportunity and fighting unemployment.

The objectives are noble and ambitious but since 2000 they have lacked a clear and effective governance mechanism. What the Lisbon Agenda has lacked from the very beginning is a management mechanism capable of overcoming the decision-making gridlock of intergovernmentalism. As suggested in Figure 11.1, the most likely consequence of an intergovernmental approach is the maintenance of different national policies where possible – i.e., the perpetuation of separate national policy regimes – or in the worst case making provisions for individual national opt-outs in particular policy arenas. During the 1990s individual national opt-outs were negotiated in order not to prevent the majority of the countries from moving forward in the integration of policy areas. The area where opt-outs became most common was in the Single Currency with the special provisions made for the UK, Denmark and Sweden.

In the case of the Lisbon Agenda the basically intergovernmental management mechanism has been labeled the “open method of coordination” (OMC). OMC requires states to participate in the achievement of the strategy’s objectives through voluntary compliance, the preparation of national action plans and the sharing of information. The soft form of governance proposed for the Lisbon Agenda institutes a highly structured system of monitoring and evaluation, but the EU budget cannot be used to provide incentives or finance programs to achieve the objectives. In addition, the Commission is not in a position to oblige member states to fulfill their stated objectives through legal or administrative sanctions.

All that is available to force member state compliance is the yearly publication of how member states have performed in achieving their national and European objectives. The approach has been described in the literature as the “naming and shaming” of under performers, but in the last analysis the procedure has not been sufficient to bring member states into compliance with the objectives.

In 2005 the Wim Kok Report pointed out all of the flaws of the OMC approach and suggested that, in part, the Lisbon Agenda be brought into the Commission's power of activity and financing through the existing powers of the Commission in training and research. However, the difficulty was: what were the mechanisms available to the Commission to constrain the member states to comply? The Kok Commission recommended a number of alternatives, such as designating a member of each government to "be in charge with carrying forward the day-to-day implementation of Lisbon," the presentation by the end of 2005 of a national action program "to engage all the forces around this key objective," mutual bench-making, and the adoption by member states of broad economic and employment policy guidelines valid for a four-year period (Kok 2004: 40–1). As a result, the report acknowledged that the open method of coordination had not satisfied the expectation generated in 2000. The only alternative now, according to the Kok Commission, is to "reshape" the EU budget and use the Community method to create incentives for member states to achieve the Lisbon targets.

The difficulties encountered in the implementation of the Lisbon objectives reflect all of the shortcomings of the intergovernmentalist approach to policy implementation at the supranational level: how to force states to comply when there is no legal base for supranational decision-making and sanctions. According to federalists, such as Altiero Spinelli, functionalist governance was ultimately limited in its federalist impact due to the lack of democratic legitimacy and the piecemeal nature of the transfer of national sovereignty. Only a full transfer of sovereignty to the European level would satisfy the need of creating a fully developed federal European system. For Spinelli only the federalist approach could in the last analysis guarantee the creation of one political system capable of formulating policies for the entire sum of the component parts rather than a complex system of institutional interaction that may or may not have guaranteed a common system of values and policies for Europe. In the bottom half of Figure 11.1 we can see that the end result of the Monnet method is a complex system of institutions and interactions that lack full democratic legitimacy.

## V. Conclusion

The European experience clearly demonstrates the complex nature of comparative analysis of federalism when institutions are changing over time in response to changing internal and external exigencies. Rather than considering this a handicap, the differentiation of patterns helps us to redefine our concepts and make them more relevant to changing conditions. The analysis presented above can help to provide answers to some of the questions presented at the beginning of the chapter. First of all, federalism is without doubt evolving and has assumed different characteristics in different geographic contexts. It is true that since 1989 some previous federal

states such as the Soviet Union and Yugoslavia have disintegrated, but new forms of state aggregations have risen in response. What has definitely changed is the ability of composite states to continue to have strong centers. The most common solution to the problems faced by federalism and making the institutions respond to socioeconomic challenges is the development of new methods of coordination and integration among component elements of the federal state. Such has been the case in the Federal Republic of Germany and Switzerland. We may argue that the increased need to find new forms of governance within as well as outside of federal and centralized states is part of the overall redefinition of the state and its functions in a modern context through a process of moving decision-making and implementation responsibilities for certain policy areas "outward" to the private market, "downward" through a process of decentralization and "upward" to supranational or international decision-making bodies. However, these different off-loading strategies differ from one political context to another. What may be possible for the countries incorporated within the European Union may not be possible for the countries participating in CARICOM or other regional organizations where the institutionalization of responsibilities at the supranational level have not been as extensive or profound in their ramifications.

These changes in the nature of political institutions and the methods by which policies are managed make it difficult to propose ideal types. This is true for both federal as well as centralized states. The pressure for finding solutions to persistent problems requires us to be increasingly realistic in our analysis and in finding solutions. In conclusion, there is no ideal federal system toward which evolving political systems need to evolve. What exists on the part of national and supranational political systems is the need to provide sound responses to the social and economic needs of their citizens. In most cases, those responses cannot be produced without innovating what political systems do, and innovation in today's global interaction requires political systems to inject certain characteristics of federalist structures.

## Notes

- 1 For a discussion of comparative federalism, see Ivo Duchacek (1970); Michael Burgess and Alain G. Gagnon (eds) (1993), and Ursula Hicks (1978).
- 2 See Altiero Spinelli's address "Towards the European Union" (1983).
- 3 An interesting parallel example of economic integration to the one offered by the EU is provided by CARICOM, the Caribbean Community, that decided in 1972 to move from constituting a free trade area (CARIFTA) to a common market in order to have a common external tariff. On January 1, 2006 CARICOM's transition from a Common Market to a Single Market was completed (CARICOM 1997; Pollard 2003).

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# Index

- ad valorem* tax, *see* property tax
- Administration & General Services, 232
- administrative accountability, 117
- Agnew, John, 89
- Agostini, Claudio A., 129
- Agranoff, Robert, 202–3, 220, 256, 272, 274
- Agreed Plan, 257, 267
- Aid to Families with Dependent Children (AFDC), 174
- Alabama, 97–8
- Alm, J., 137
- Alt, J.E., 137–8, 156
- alternative form of government system, 197n3
- American federal system/American federalism, 167–97, *see also under* US
- 21<sup>st</sup> century American federalism, 194–7
- ambivalent federalism, 56
- American federalist experiment, radical implications, 35
- and 9/11 terrorist attacks, 177
- California experience, 193–4
- complexity and messiness of, 196
- defining characteristic of, 168
- development, 169–79
- devolution and regulatory federalism, 173–6, *see also* devolution
- dual federalism, 170
- establishment of, reviewing, 178
- evolution and devolution of, 168–9
- federal transfers, 180–3
- from new federalism to less federalism, current proposals, 177–9
- from the 1930s to 1970s, 171
- Great Society-Creative Federalism program, 190
- Head Start program, 177
- in 1907, 167
- intergovernmental revenues and transfers, 179–80
- and Kingdom of Italy, 50
- local spending and intergovernmental revenues, 186–8
- mandates and preemptions, 191–2
- municipal revenues, 189–91
- New Deal, the Great Society and creative federalism, 170–1
- new federalism and a “sorting out”, 171–3
- people over places, 176–7
- philosophical debate over, 195
- role of government in, 167
- state and local intergovernmental revenues, 183–91
- state governments and the federal government, transfer behavior, 187
- state spending and intergovernmental revenues, 185–6
- strength and the weakness of, 194
- tax and expenditure limitations (TEL’s), 192–4
- versus Canadian federal and legal systems, 31–2
- Amin, Ash, 72
- Anderson, William, 259, 261
- Annala, C.N., 137, 164
- anti-terrorism efforts, 177–8
- Anton, Thomas, 10, 205–6, 216–18
- Apalachicola-Chattahoochee-Flint river system, 97
- Area Agencies on Aging (AAA), 258
- Argentina, 252
- artificiale* term, 46
- Ashford, Douglas E., 250
- Asia, 48
- Associated state, 3
- “associational revolution”, 68
- Atlanta, 95–6
- Austin, 89–90
- Australia, 2, 252–3, 261, 264
- Australian Mutual Recognition Scheme, 270
- local income tax in, 140
- Austria, local income tax in, 140



- autonomy, 254
  - devolutionary autonomy, 254
  - federal autonomy, 254
  - nonterritorial or communal autonomy, 254
- “bail-out” term, 135n21
- balanced tax system, 138
- Bardhan, Pranab, 130
- Bednar, Jenna, 219
- Belgium, 21, 23, 99, 248, 254, 297
  - local income tax in, 140
- benefit-tax belief, 113
- Benelux Customs Union, 297
- Bensel, R.F., 95–6
- Bird, Richard M., 116, 137, 157
- Blackmun, Justice, 209
- Bonaparte, Napoleon, 41
- Boston, 89–90, 96
- boundaries and space, 98–9
- Bowman, Ann O’M., 22, 25, 270
- Brazil, 23, 26, 252, 263
- British North America Act of 1867, 30–1
- British parliamentary system, 36
- Brueckner, Jan K., 128
- Bryce, James, 36
- budget constraints, 121, *see also*
  - hard-budget constraints;
  - soft-budget constraints
- Budget Council, 264
- Bund, 263
- Bundesrat, 263–4, 266, 268, 292
- Bush, George Herbert, President 174, 213
  - American federal system under, 177
- Cabela, 152
- California, 111, 118, 160
- California experience, 193–4
- Canada, 2, 21, 23, 28, 111, 138, 158–9, 248, 252–3, 261, 263, 268
  - Canada Mortgage and Housing Corporation (CMHA), 162
  - Canadian Confederation in 1867, 42
  - Canadian constitutional settlement, 1867, 31
  - Canadian municipal bonds, 160–3
  - Canadian Pension Plan (CPP), 161
  - Canadian political history, 29
  - local income tax in, 140
  - Upper Canada “the Family Compact” in, 30
- Carter, Jimmy, 211
  - and United States Case 1789–2006, 211
- Castiglioni, Luigi, 38
- Cattaneo, Carlo, 37–49
  - on America discovery of federal principles applicability, 47
  - American Civil War and, 42
  - on American and Swiss federation, 44
  - on American model of rule, 39
  - on American political experiment, 37
  - on *artificiale*, 46
  - on “Chinese stagnation” metaphor, 47
  - on common language, 45–6
  - communes, 43–4
  - on constitutive dynamics of humans, 45–6
  - distinctiveness, 38
  - on federal principles of organization, 44
  - on individuals and society, 45
  - on Italians in Restoration Europe, 39
  - on local foundations of self-governance, 43
  - on Milanese Enlightenment, 48
  - on movement and plurality, 47
  - on multidimensional and complex world, 47
  - on Nullification Controversy, 37
  - on philosophy, 46
  - on public urban life in Asia today, 48
  - on religion, 38
  - on self-government and human progress, 46
  - on sovereignty, 45
  - on state, 48
  - on Tocqueville’s work, 38
  - Tocqueville and, 39
- Cavalieri, Enea, 52–4
  - on Canadian binational and bicultural experience, 53
  - on federal principles, 52
- Cavour, Camillo Benso di, 38
  - on Ferrara’s memorandum, 51
- centralized government and administration, 4, 52
- Chapman, Jeffrey I., 13, 104
- Chicago, 96

- Chicoine, D.L., 147
- China, 47, 298
- Chubb, John E., 215–16, 218
- Cities' fiscal structures, 7
- City of New Orleans, 147
- civil society organizations, 81
- Clarke, Susan E., 12, 22, 24, 201
- Clay, Henry, 86
- Clinton, Bill, 212
- coalitional strategies, 64
- "coercive federalism", 11, 56
- collaborative policy-making, 250, 265, 267
- Commission on Intergovernmental relations, 136, 147, 188, 192, 210
- Committee on Federalism and National Purpose, 210
- common municipal services, efficient and equitable service delivery in, 229
- contracts, 229
- cultural and arts programs, 231
- franchises, 229
- grants, 229
- health & human, 230
- parks & recreation, 231
- public safety, 230
- public utilities, 230
- public works, 230
- services, 230
- subsidies, 229
- support functions, 231
- transportation, 230
- vouchers, 229
- common set of curriculum-based external exit exams (CBEEEs), 237
- compacts, interstate, 97–8
- Compagnoni, Giuseppe, 38
- comparative tax research, 136
- competitive federalism, 223
- competitive sourcing, 246
- Compromise of 1850, 100n1
- Condominium, 3
- Confederation, 3
- Confederation settlement of 1867, 29–30
- Conlan, Timothy, 212, 222n10
- Connecticut, 160
- Connor, Walker, 253
- Consociation, 3
- constitutional and political framework, 9, 12–13
- causes and consequences, 22
- constitution-making, 21
- governance within, 9
- consumption tax base, in US, 112–13
- Continental Congress, 92
- contracting/outsourcing, 246
- "cooperative federalism", 259
- cooperative practices in federal systems, 248–83, *see also under* intergovernmental policy management
- "coordinate authority" model, 7
- correct-tax assignment, 116
- corruption and federalism, 107
- cost shifting, and local governments, 125
- Council of Australian Governments (COAG), 264, 270
- County Economic Growth Partnership (WCEGP), 276
- Court, Taney, 208
- covenant devices/ideas
- Confederation in 1867, 30
- federative principles, 29
- in the making of Confederation, 29
- reasons, 29
- Curtis Ventriss, B.J., 208
- Czechoslovakia, 2
- local income tax in, 140
- Daimler-Chrysler corporation, 91
- Dallas, 96
- Davis, Rufus, 206–7, 217, 221
- "death tax", 134n12
- debentures, in Canada, 160
- debt, 13–14
- debt financing, 158–9
- debt issuance process, 162–3
- debt securities, by American state and local governments, 158
- and taxes, 138
- decentralization, 77, 108–9, 116, 130
- decentralized system, basic
- governance structure, 123
- Declaration of Independence, 31
- deconcentration movement, 108
- Delaware, 153

- democratic and newly-democratizing nations, challenge to, 8
- democratic despotism, 39
- democratic development, in 19<sup>th</sup>-century Europe, 27
- democratic federal polities, 21
- democratic governance, 79
- Denmark, 224
- local income tax in, 140
- Denver, 96
- Derthick, Martha, 55, 169, 221
- devolution
- de facto* devolution, 174
- “Devolution Revolution”, 213
- President Reagan’s version of, 174
- and regulatory federalism, 173–6
- Diamond, M., 56, 169
- disarticulation, 69
- domestic capital market, 158
- domestic tax-exemption, 158
- Donahue, John D., 217
- “dual federalism”, 170
- Reagan’s definition, 206
- e-commerce, 113
- taxing, 133
- economic theory, 109
- economic, social, cultural, and political characteristics in federal system, 25
- economic accountability, 117
- education, 232
- educational management organizations (EMOs), 236
- higher education, 233
- efficient and equitable service delivery, in federal system, 223–47
- alternative service providers, 239–41
- alternative service-delivery arrangements, 224
- for common municipal services, 229, *see also individual entry*
- contracting out or outsourcing, 224–6
- elementary and secondary education, 235–9, *see also individual entry*
- equity and efficiency, trade-off between, 243
- franchising, 226–7
- government agencies in, 239
- government contracting, 225–6
- grants/subsidies, 227
- health care industry, 214–42
- non-profit firms in, 240–1
- private for-profit firms in, 239
- public-private partnership, 228
- state contracting out after welfare reform, variations in, 234
- states “privatizing” programs or services, 1997, 232–4
- by US local governments, 228–32
- by US state governments, 232–5
- vouchers, 227–8
- Eisenhower, President, 196, 222n9
- and United States Case 1789–2006, 210
- Elazar, Daniel J., 29, 65, 77, 89, 176, 201n2, 248, 253
- of American federalism, 4
- associated state, 3
- condominium, 3
- consociation, 3
- Elazar’s typology of federal political systems, 3
- federacy, 3
- federation, 3
- joint functional authority, 3
- league, 3
- union, 3
- elementary and secondary education, efficient and equitable service delivery and, 235–9
- charter schools, 236
- private educational management organizations (EMOs), 236
- vouchers, 236
- Elmore, Richard F., 256
- “empirical federalism”, 220–1
- Eskeland, Gunnar S., 130–1
- Esteller-More, Alejandro, 120, 128
- Europe, 42, 49, 69
- Cattaneo’s response, 37–49
- Congress of Vienna, 33
- contemporary Europe, democracy implications, 53–4
- European Economic Community (EEC), 298
- European political thought, 23
- European state challenged, 33–4
- Francesco Ferrara’s response, 49–51
- lessons from America, 34–51
- Tocqueville’s response, 35–7

- European Union (EU), 71–2, 109, 295–9  
 institution building and  
   policy-making in, theoretical  
   approaches, 296  
 institutional linkages in a  
   confederation, 2  
 intergovernmentalist approach in,  
   295  
 neofunctionalist approach in, 295  
 executive federalism, 261
- Family Compact, 30  
 Fathers of Confederation, 28  
 FEANTSA (European Federation of  
   National Organizations Working  
   with the Homeless), 65  
 “federal liberty”, 29  
 federal polities  
   definition, 2  
   images of, 6–8  
 federal potentials  
   self-governing capabilities in societies  
   with, 27–54  
 federal structures  
   49<sup>th</sup> Parallel, 74  
   and complex conditions, 76–7  
   decentralized federal system, 75  
   decidedly non-central orientation, 7  
   and leadership, 77–8  
   and learning networks, 75–6  
   and problem solving, 74–5  
   smart border concept, 75  
   standard images of, 7  
 federalism/federal system, *see also*  
   *individual entries*  
   in the 21st century, 288–304, *see also*  
   operational federalism  
   in addressing governance dilemmas,  
   55  
   administrative structure in, 8  
   alternative types of, 28–32  
   American versus Canadian federal and  
   legal systems, 31–2  
   assignment concerns, 110–12  
   assignment problem and general  
   revenue sources in, 110–18  
   base and rate definitions and, 115–18  
   characteristics, political values of,  
   108  
   characterization of, 4  
   Clint Bolick’s definition of, 293  
   composite and inductive nature of,  
   288–9  
   concerns for, 118–21  
   constitutional and political  
   framework, 9  
   content and functional changes over  
   time, 290  
   coordinate authority model, 7  
   corruption and, 130–1  
   cyclical, 108  
   defining, complexity in, 3  
   definition, 4, 201  
   dynamic federalism, 108  
   dynamics, in national and  
   supranational political systems,  
   1–17  
   efficient and equitable service delivery  
   in, 223–47, *see also under* efficient  
   and equitable service delivery  
   Elazar’s typology, 3–4, *see also* Elazar,  
   Daniel J.  
   essentials of, 9–11  
   federal design principles, 52–3  
   federal government, specific powers  
   of, establishment, 11  
   “federal theology”, as the covenantal  
   basis, 29  
   federal-tax rate, Canadian provinces,  
   128  
   fiscal framework, 10  
   Forsyth definition, 295  
   of government, changing economic  
   effects on, 107  
   and governance concepts, linking,  
   81–4, 293  
   from a governance perspective, 77  
   importance of governance to, 24  
   “inclusive authority” model, 7  
   institutional framework of, 69  
   intergovernmental fiscal flows, 105  
   intergovernmental revenue flows,  
   120–1  
   Justice Louis Brandeis’ assessment, 6  
   local governments and, 136  
   as a metaphor 56–8, *see also*  
   metaphor  
   Nathan’s definition, 108  
   need for, 73–8  
   non-territorial aspects of, 98–9  
   non-territorial, 100n4  
   in North America, 28

- federalism/federal system, *see also individual entries – continued*  
 as opportunistic, 108  
 policy framework, 10–11  
 as a political idea and institutional design option, 55–84, *see also* governance  
 political representation and, 292–3  
 political strategy of, 109  
 political theory, 26  
 polycentric nature, 29  
 pro-government, 108  
 regional systems and, taxing powers of, 292  
 in the regionalist cases in Europe, 292  
 review of, 108–10  
 secessionist sentiments and movements and, 25  
 state-centric approach to, 55, 78  
 subnational governments in, 117, 130  
 subsidiarity, 77  
 as a system of divided powers, 5  
 temporal dimension, 16–17  
 theory of, 24  
 types of, 27–54, *see also under* federal potentials  
 in the United States is more than, 29  
 Watts' report on, 2
- federal mandates, 192
- federation, 3
- Ferrara, Francesco, 49–51, *see also* Sicily  
 on American federalism, 50  
 prognostication of, 51  
 on Scottish system, 50  
 on Sicily and Italy union, 50  
 on "The American model", 51
- Ferrari, Giuseppe, 40–1
- Finland, local income tax in, 140
- fiscal framework/fiscal federalism, 10, 13–14, 101–97  
 autonomy/responsibility, 106  
 fiscal centralization, 109  
 fiscal competition for industry, 127  
 fiscal decentralization, state and local public expenditures, 109–10  
 "fiscal illusion" problem, 8, 18n7  
 fiscal relationships negotiation and adjustment, 264
- fiscal system diversity, 104–5  
 and intergovernmental revenues, in US, 167–97, *see also* American federal system  
 and political institutional concerns, 123
- Fisher, G.W., 144–5  
 on property tax, 144–5
- Fiske, E.B., 238
- Fisman, Raymond, 130
- Flemish, 98
- Florestano, Patricia S., 269
- Florida, 97–8, 149  
 elementary and secondary education in, 236
- France, 35, 41–2, 254, 298  
 local income tax in, 140
- Franchetti, Leopoldo, 52
- franchising, 246
- Francophone analysts, 29
- Franklin, Benjamin, 38
- Franklin, D., President, 171
- Frederickson, H. George, 69
- French Revolution, 44
- "fuzzy federalism", 57, 78  
 fuzzy logic, in governance, 84n1  
 public and private sectors, distinction, 57
- Gansler, J.S., 226, 247n2
- Garibaldi, 49
- Garreau, Joel, 96–7
- Gatti, Roberta, 130
- Geddes, M., 81
- General Revenue Sharing (GRS), 172
- generally accepted accounting standards (GAAP), 1
- Georgia, 93, 97–8
- Germany, 2, 26, 33, 248, 252, 260–1, 264, 266, 268, 279  
 local income tax in, 140
- Giertz, J.F., 147
- Gimpel, J., 87
- Glendening, Parris N., 5, 56
- globalization, 26, 70, 127  
 pressures, 69  
 and regionalization processes, 72
- Goetz, Klaus, 269
- Goldsmith, Stephen, Mayor, 226
- governance/governance  
 perspective/governance processes of

- federalism, 55–84, *see also* regional governance
  - attributes, 59–60
  - civil society, resurgence of, 68–9
  - construction of territorial actors, 71–3
  - contexts encouraging, 57–8
  - conventional federalism concepts, 58
  - coordination & cooperation issues, 61
  - diminished national capabilities, 69–70
  - of economic affairs, 297–301
  - economic governance, 300
  - effectiveness of, 80
  - failures, 82–3
  - good governance, design, 83–4
  - governance game, 58–67
  - governance strategies and governance tasks, issues, 61
  - governance, definition, 293
  - governance, need for, 67–73
  - governing persons, 78–9
  - government responsibilities, in federal system, 15
  - integrating issues, 61
  - interdependency and complexity, 68
  - Lisbon Agenda/Strategy, 301–2
  - local and regional governments, 70
  - multi-level governance processes, 69
  - as an organizing framework, 58
  - of social policy, 301–3
  - steering issues, 61
  - supranational and national governments, 71
  - thinking federally, 78–81
  - through hierarchical strategies, 62–3
  - Type I and Type II, 59, 82, 299
  - typologies, 60–2, *see also* markets; Hierarchical strategies; Network strategies
  - underdeveloped decision capacities, 71
  - Wim Kok Report, 303
- government finance, *see also* fiscal framework
  - dollar replacement activities, 114
  - interjurisdictional competition, 126–30
  - local lump sum grants, 114
  - resource-extracting systems, 103–4
- grants/subsidies, 227, 246
- Gray, B.H., 241
- Great Depression of the 1930s, 105, 144, 170
- Great Society-Creative Federalism programs, 190
- Greece, local income tax in, 140
- Greenfield, Kent R., 39
- Grodzins, Martin, 168, 176, 179, 206
- Guizot, Francois, 47
- Gulf of Mexico, 95
- Hamilton, A., 93
- Handy, Charles, 76
  - on federalism, 77
- Hanf, Kenneth, 265
- hard budget constraints, 4, 131
  - central government and, 122
  - requirements, 124
  - and soft-budget constraints, 121
- Hawaii, 153
- health/health services, 105, 108, 121, 143, 157, 171, 225, 244, 251–2, 264
  - health care domain, 242
  - health care domain, ownership patterns and trends by, 242
  - health care industry, 241–2
  - health insurance, 177, 183, 205, 208, 214, 222n2
  - Municipal use of contracts for, 230–1
  - non-profit firms for, 15
- Hegel, G.W.F., 37
  - on individual's freedom, 36
- Hernandez-Murillo, Ruben, 128
- Hesse, Joachim Jens, 266
- heterogeneity theory, 48, 240
- hierarchical strategies, 60
  - and networking governance strategies, 79
  - encouraging collaboration, 63
  - for cooperation and coordination, 62–3
  - new institutions, establishing, 63
- Hildreth, W.B., 14, 105
- Hill, Jeffrey Hill, 218
- Hobbes, T., 29
- Hoene, C.W., 14, 105
- Holland, 297
- “homestead exemption”, 145, 147
- Hooghe, Liesbet, 59, 82
  - horizontal federalism
  - horizontal intergovernmental concerns, 121

- Hooghe, Liesbet – *continued*  
 interstate/intergovernmental relations, 268–75  
 theoretical framework, 121–6
- Houston, 95
- Hungary, local income tax in, 140
- Huther, Jeff, 130
- Iceland, local income tax in, 140
- Illinois, 148–9
- income tax, 112, 134, 143  
 deduction, 119  
 income-tax cuts, under Bush administration, 113  
 local income tax, 156–7
- India, 2, 23, 26, 261, 264
- Ingram, Helen, 218, 256
- Inman, Robert P., 125, 135n21, *see also*  
 cost shifting  
 on hard-budget constraints, 126  
 local public sector, 134n19
- institutional relationships, 6, 11
- intentional federalism, 56
- interdependence theory, 240
- intergovernmental grants, 134n14  
 in the US, 105–6
- intergovernmental management (IGM),  
 249–50, *see also* intergovernmental  
 policy management  
 empirical examination, 272  
 micro IGM, 271–5
- intergovernmental policy management,  
 cooperative practices in federal  
 systems, 248–83, *see also* horizontal  
 federalism  
 complexity and the need to operate  
 collaboratively, 257–61  
 economic development  
 policy/program tools, 273  
 first minister's and ministerial  
 conferences, 261–5
- intergovernmental relations, *see*  
*separate entry*
- interlocal relations, horizontal  
 service and policy networks,  
 279–82
- joint policy-making, 265–8
- macro IGR, 259–61
- micro IGM, 271–5
- in New York, 256
- packaging programs, 276–9
- place, autonomy and the  
 non-prefectural tradition, 252–7
- prefectural administration, 254
- Salem, Indiana's industrial park  
 expansion project, 277–8
- Southern Air Principles, 270
- tax increment financing project,  
 sequence of cooperative actions,  
 275
- territorial organization, 253
- welfare state's "open compartments",  
 250–2
- intergovernmental relations (IGR),  
 249–50, *see also* intergovernmental  
 policy management  
 administrative practices, 262  
 economic devices, 262  
 legal approaches, 262  
 macro IGR, 259–61  
 political/government bodies, 262  
 in public finance system, 10  
 structures, 7  
 twenty-seven instruments of, 262
- intergovernmental revenue flows,  
 113–15, 120–1
- horizontal intergovernmental  
 concerns, 121
- interjurisdictional competition, in  
 government finance, 126–30  
 subnational-fiscal competition, 129
- interlocal relations, horizontal service  
 and policy networks, 279–82
- Internal Revenue Service, 111
- Interreg IIC and IIIC program, 72
- Interstate Networks, 65  
 interstate compact as legal, 269
- Iraq, 55
- Ireland, 4  
 local income tax in, 140
- Israel, 2, 54n1
- Italy, 2, 25, 42, 49, 52, 55, 248, 254,  
 260, 298  
 local income tax in, 140
- Jacksonville, 95
- Jacobson, David, 94
- Japan, 254–5  
 local income tax in, 140
- Johnson, Lyndon B., President, 171,  
 176
- "joint-decision trap", 266

- Joint functional authority, 3  
 Juvenile rehabilitations, 233
- Kansas, 89  
 Kaufman, Franz-Xavier, 266  
 Kelly, R., 149  
 Kenyon, D.A., 15, 202  
 Key, V.O. Jr., 95  
 Kincaid, John, 22, 56, 174, 206, 215–16  
 Kjellberg, Francesco, 253  
 Kollman, Ken, 220  
 Korea, local income tax in, 140  
 Krane, Dale, 249  
 Kraynak, Robert P., 54n1
- Labor, 115, 208, 227, 233, 251, 257,  
 270, 301–2  
 Ladd, H.F., 238  
 Länder, 263, 266, 268–9, 279  
 land tax, 113  
 Lane, Jan-Erik, 26n1  
 Law for the Promoting of  
 Decentralization, 255  
 leadership in federal systems, 77  
 Legislative theory, 216  
 Leitner, Helga, 73  
 Leonardi, Robert, 16, 69, 74  
 liberal democracy, challenge of, 42  
 Liberalism, 33, 36–9  
 Liebschutz, Sarah F., 256  
 Lisbon Agenda/Strategy, 301–2  
 Litvack, Jennie, 130  
 local cost shifting, 125, *see also* Inman,  
 Robert P.  
 local foundations of self-governance,  
 43  
 local government own-source revenues  
 and debt financing, structure and  
 stress, 136–64  
 debt financing, 158–9  
 debt issuance process, 162–3  
 federalism in, 163–4  
 income tax, 156–7  
 investors, 161–2  
 local government tax sources, 138  
 local income tax, alternative  
 administrative approach, 156  
 local option tax, 152  
 in OECD countries, 138–40  
 primary own-source revenues, 143–4  
 property tax in, 145  
 sales tax, 151–6, *see also individual  
 entry*  
 securities, nature of, 159–60  
 service charges, 157–8  
 in US, 140–3  
 local government(s), 118  
 and cost shifting, 125  
 local and municipal revenues from  
 intergovernmental sources, 189  
 local-government autonomy solution,  
 111  
 local self-governance, 44  
 own-source revenues and debt  
 financing, structure and stress,  
 136–64, *see also individual entry*  
 perspective, federalism in, 163–4  
 territories, 91  
 in US, service-delivery alternatives  
 used by, 228–32
- Lombard Plain, 46  
 Lombardy-Venetia, 39, 42, 47, 50  
 Louisiana, 147, 160  
 Low Level Radioactive Waste Act of  
 1980, 98  
 Lower (Quebec) and Upper (Ontario)  
 Canada, 28  
 Lowndes, Vivian, 81  
 Luxembourg, 297  
 local income tax in, 140
- Maastricht Treaty's* principle, 109  
 Madison, James, 169  
 Maine, 98  
 Majoritarian rule, 30  
 Malaysia, 261, 264  
 Mark, Stephen T., 128  
 “marketpreserving federalism”, 4  
 markets, 60–1  
 Marks, Gary, 59, 82  
 Marx, Karl  
 on Hegel, 36  
 Massachusetts, 89, 92–3  
 Mazzini, Giuseppe, 33–4, 36–7, 40, 42  
 McClure, Charles E. Jr., 110, 112, 133n4,  
 256, 272, 274  
 public-sector efficiency, 112  
 on tax-assignment problems/solution,  
 111–12  
 support of benefit taxes, 111  
 McDonald, F., 92  
 McGuire, Michael, 256, 272, 274



- MECs (members of executive council), 264
- Medicaid program, 212, 215, 271
- Memphis, 96
- Mencken, H.L., 201n1
- Mental health & retardation, 233
- "menu federalism", 56
- metropolitan political system, 8
- metaphor  
     federalism as, 56–7  
     of the global web, 70
- Mexico, 2  
     local income tax in, 140
- Miami, 95
- Mikesell, John L., 155–6  
     codes tax base, 156
- Mill, John Stuart, 36–7
- Minnesota, 149
- Mississippi, 151
- Mobile, 95
- modern local self-government in  
     Western countries, 253
- Montana, 153
- Mookherjee, Dilip, 130
- "moral federalism", 56
- Motorola electronics, 269
- multi-level governance processes, 69
- multi-organizational interdependencies,  
     281
- multi-state sections  
     politics adhering, 94
- Municipal International Cooperation  
     (MIC), 64
- Municipal revenues, 189–91
- Musgrave, R.A., 213–14, 221
- NAFTA, 72
- Nanetti, Raffaella Y., 16
- Naples, 49
- Nathan, Richard P., 222n9
- National Association of Attorneys  
     General (NAAG), 271
- National Bureau of Economic Research,  
     130
- National Governors Associations (NGA),  
     271
- National Income and Product Accounts  
     (NIPA), 141
- nation-states  
     and centralized, regionalist and  
         federal nation-states, 294  
     nation-state authority, 108
- Natural resources & environmental  
     protection, 233
- Netherlands, 21  
     local income tax in, 140
- network strategies  
     Casa Pia de Lisboa project, 65  
     CITYNET, 65  
     for cooperation and coordination,  
         63–7, *see also* FEANTSA  
     cross-border and transnational, 67  
     at different levels, advantages and  
         issues, 66  
     Eurocities, 65  
     interstate networks, 65  
     Metrex, 65  
     Municipal International Cooperation  
         (MIC), 64  
     networks across scales, 64  
     networks, need for, 67–73, *see also*  
         network strategies
- New Hampshire, 153
- New Jersey, 92
- New Mexico, 153
- New Orleans, 95
- New York, 92, 96, 148–9, 160
- New Zealand, local income tax in, 140
- Nigeria, 2
- 9/11 attacks  
     and cross-border governance network,  
         74
- Nitting, Gary, 270
- Nivola, Pietro, 174
- Nixon, Richard, President, 171–2, 197,  
     217, 222n7
- No Child Left Behind law of 2001,  
     214
- "non-distribution constraint", 240
- Non-governmental organizations  
     (NGO), 68
- non-profit firms, 240–1, 245
- non-state regionalism, 96
- North American federalism, 28
- North American Free Trade Association  
     (NAFTA), 298
- Northwest Ordinance of 1787, 93
- Norway, local income tax in, 140
- Oates, Wallace E., 109, 213, 215
- Oklahoma, 88–9
- Older Americans Act, 258, 260, 261
- Ontario, 159

- operational federalism, European
  - experience with, 288–304
  - “asymmetrical” regionalization, 292
  - definition, 290
- Oregon, 153
- Organization for Economic Co-operation and Development (OECD), 72, 137
  - local governments in, 138–40
- Orleans parish, 147
- Ormsby, W., 30
- Ostrom, Elinor, 25
- ownership patterns and trends, by
  - health care domain, 242
  
- Pacific NorthWest Economic Region (PNWER), 67
- Palmer, R.R., 33
- parliamentary federal systems, 260
- Partnership for Regional Infrastructure Security (PRIS), 67
- Pearce Plan, 87–8
- Peirce, Neil, 56
- Pennsylvania, 92
- Pension plans in America, 161
- Peterson, Paul E., 213, 216–17
  - City Limit*, 4
  - The Price of Federalism*, 4
- Philadelphia, 96
  - Philadelphia Convention of 1787, 28
- Piedmont, 40
- Poland
  - local income tax in, 140
- policy cooperation, 16
- policy framework, 10–11, 15–16
- political-tax limits, 118
- Portugal, 3, 292
- potential tax bases and tax theory, 112–13
- power deconcentration, 108
- “pragmatic federalism”, 56
- prefectural administration, 255
- Pressman, Jeffrey, 256
- privatization
  - private for-profit firms, 239–40
  - private sector participants, 81
  - in US vs. Europe, 243–5
- property tax, 113, 143–51
  - adequacy, 148
  - assessment, 147
  - as a benefit tax, 113
  - complexity, 148
  - constraint, 148
  - equity, 148
  - local income tax in, 140
  - property tax structure index, 148–51
  - and retail sales taxes, ranking, 136
  - structure, contemporary aspects, 145–8
- public financial tools (PFT), 127
- public-private partnership, 246
- “puppy federalism”, 56
- “pure theory of local expenditure”, 214
  
- Qian, Yingyi, 219
- Quebec, 31
  
- Reagan, Michael, 206
- Reagan, Ronald, 173, 181, 212, 214, 222nn9, 10
- Reeves, Mavis Mann, 5
- Regional Devolution Act, 255
- regional governance
  - concept, 72
  - ideological agendas, 73
- regional inequality, 26
- regional networks and agreements
  - proliferation, 72
- regionalism, 71
- regulatory federalism, 174
- Rehnquist, Justice, 208
- Reich, Robert, 70
- Republic, local income tax in, 140
- “revenue” bond label, 160
- revenue sources, subnational
  - governments’ searches for, 107
- revolts of 1848, 40
- Richmond, 96
- Riker, William, 4, 201n3
- Rivlin, A., 205, 214, 217
- Rodden, Jonathan, 130–1, 133n3
- Rome Treaty, 298–9
- Roosevelt, Franklin D., President, 171
- Rosmini, Antonio, 38
  - on Tocqueville’s work, 38
- Rubin, Edward L., 56
- Russia, 2, 263
  
- Saavedra, Luz A., 128
- Sabetti, Fillippo, 23
- Salem, Indiana’s industrial park
  - expansion project, 277–8

- sales on Internet, 152
- sales tax, 113, 134n8
  - adequacy, 153
  - sales tax structure index, 153–6
  - sales tax structure, contemporary aspects, 151–3
  - tax base, 153
  - tax rate, 153
- San Antonio, 95
- San Francisco, 96
- Savannah, 95
- Sawhill, I.V., 238
- Schalter, C.A., 110
- Scharpf, Fritz., 266
- Scheiber, H.N., 176
- Schlesinger, M., 241
- Schuknecht, J.E., 87
- Scottish system, Ferrara on, 50
- sectionalism, 93, 95
  - in the US, 94–7
- securities
  - nature of, 159–60
  - state and local government securities, 159
- selfgovernance, 42–4
  - Cattaneo on, 43
  - foundations, 45–9
- self-rule, 34
- service charges, 157–8
- Shah, Anwar, 130
- Sharpe, L.J., 253
- Sheppard, Eric, 73
- Sicily, 34, 50, *see also* Ferrara, Francesco
  - American political experiment to, 51
  - in Italian unification, 49
  - and Italy, union, 50
  - Naples annexed by, 49
  - self-governance of, 51
- Siedentop, Larry, 27
- Simeon, Richard, 263
- Sjoquist, D.L., 147
- Skelcher, C., 81
- Slovak, local income tax in, 140
- Smith, Adam, 137, 156, 238
- social forces, space and boundaries, 86–100
  - Texas, 86–9
  - border spanning, interstate compacts, 97–8
- social origins theory, 240–1
- soft-budget constraint, 121, 134nn14–15
  - in decentralized countries, 121
  - private sector firms and, 134n16
- Sole-Olle, Albert, 120, 128
- Sonnino, Sidney, 52
- South Africa, 2, 254, 260, 264
- “Southern Air Principles”, 270
- space
  - and colonies and states, 92–4
  - in a physical sense, 89
  - and places and borders, 89–92
- Spain, 2, 4, 21, 34, 42, 248, 252, 254, 260, 279
- “splintering” urbanism, 7
- state
  - in Cattaneo’s view, 48
  - disarticulation of, 69
  - hollowing out of the, 70–1
  - interstate compacts, 97–8
  - and local governments, revenue source for, 14
  - and local tax systems, 126
  - state-centric model, 78
  - state governments in the US, service-delivery alternatives used by, 232–5
  - state ownership of business, 244
  - states “privatizing” programs or services, 1997, 232, 234
  - state spending and intergovernmental revenues, 185–6
  - state tax, 113
  - strategic interactions among, 128
  - sub-state political jurisdictions, 159
  - union of states, 295
- Streamlined Sales Tax Project, 152
- subnational-fiscal competition, 129
- subsidiarity, 77, 133n1
- supply-side theory, 240
- Sweden, 21
  - local income tax in, 140
- Switzerland, 2, 21, 40
  - local income tax in, 140
- Tampa, 95
- Tannenwald, Robert, 117, 121, 126–7, 129
- tax assignment, 110
  - based on past political bargaining in a particular historical situation, 112
  - problems and revenues, 107

- taxes
- assignment, *see* tax assignment and benefits at subnational level, 131
  - state-local relationships in, 119
  - tax and expenditure limitations (TEL's), 192–4
  - tax differences, government jurisdictions and, 137
  - tax evaluating, 137
  - tax inequity, 146
  - tax interdependencies, 119–20
  - tax limitations, politics of, 118–19
  - tax policy and fiscal decentralization, 137
  - tax structures, 14, 107
  - tax structures, identification, 137
  - tax system balanced, *see* balanced tax system
- Temporary Assistance for Needy Families (TANF) program, 174
- Texas/Texas territory, 86–9, 98, 148
- Bell Plan, 86–7
  - Benton Plan, 86
  - Pearce Plan, 87–8
  - proposals for carving up, 86
  - proposals for dividing, 88
- Thatcher, Margaret, 244
- “The American model”, advantages, 51
- Thrift, Nigel, 72
- Tiebout, Charles, 112, 214
- Tocqueville, Alexis de, 34–7, 53, 56
- on American model of rule, 39
  - on American townships, 43
  - on democracy, 36
- Turkey, 254–5
- Turner, F.J., 94–5, 100n7
- Tuscany, 50
- tutelage* process, in prefectural administration, 254
- Unfunded Mandates Reform Act (UMRA), 174
- United Kingdom, 2
- local income tax in, 140
- United States (US), 2, 38–9, 92–3, 108, 111–12, 113, 117, 134n15, 138, 248, 252–3, 263
- ACIR report, 210, 213
  - Burger Court years (1969–86), 208
  - commissions, committees and advisory groups, 209–11
  - Committee on Federalism and National Purpose, 210
  - consumption tax base, 112
  - corporate-income tax in, 119
  - cost shifting in, 126
  - different governments in, 217–19
  - division of powers, 206–7
  - federal principle in historical perspective, 207
  - federalism, evolutionary pattern, 55
  - fiscal federalism, 213–15
  - fiscal federalism and
    - intergovernmental revenues in, 167–97, *see also* American federal system
  - hierarchical strategies in, 63
  - intergovernmental grants, 120
  - local governments in, 140–3
  - local income tax in, 140
  - modern version of tax limitations of, 118
  - pension plans in, 161
  - political writing, 135n21
  - Presidential leadership, 211–13
  - revenue sources, variation of, 115
  - Rural Development Councils, 267–9
  - state and local government securities, 161
  - subnational governments, 131
  - Supreme Court clarifications, 207–9
  - theoretical versus actual tax base, 112
  - US Civil Rights Commission, 96
  - US Securities and Exchange Commission, 159
  - vs. Europe, privatization in, 243–5
  - Warren Court years (1960–69), 208
- Vaillancourt, Francois, 116
- Vermont, 98
- elementary and secondary education in, 236
- Vienna, 34
- Virginia, 90–3, 228
- Voit, William Kevin, 270
- Volden, Craig, 220
- vouchers, 227–8, 246
- Walker, David B., 147
- Wallace, Helen, 69
- Washington County Economic Growth Partnership (WCEGP), 276

- Wasylenko, Michael, 127  
Watts, Ronald, 2–3, 261–4  
wealth and tax systems, 107–33  
Weingast, Barry R., 4, 219  
Weissert, Carol S., 15, 202, 218, 223  
Welfare-state centralization, 108  
Weller, Patrick, 264  
Wellisch, Dietmar, 115  
Westminster model, 32  
Wheare, K.C., 206  
Wildasin, David E., 123  
Winthrop, John, 29  
World Bank, 72, 108  
    and decentralization strategies,  
    109  
Wright, Deil S., 10, 249, 252  
Yugoslavia, 25  
Zimmerman, Joseph, 10