

Polycentric Polity: Genuine vs. Spurious Federalism¹

GIUSEPPE EUSEPI, RICHARD E. WAGNER*
Sapienza University of Rome; George Mason University

Federalism is commonly described in contradictory fashion as involving both competition and decentralization. These descriptions may appear similar on the surface, but they emanate from contradictory analytical orientations. Competition entails a polycentric arrangement of competitors where there is no locus of control over the arrangement. In contrast, decentralization is a monocentric arrangement that involves a locus of control. To treat federalism as a method for decentralizing governments leads to a spurious form of federalism because the object that has been identified is not genuinely a competitively organized system of government. Genuine federalism requires a polycentric arrangement that is organized through openly competitive processes. In contrast, the spurious form of federalism allows hierarchy to trump open competition.

1. KNOWLEDGE, COMPETENCE AND COMPETITION

Federalism is a form of government in which individual citizens are connected directly to two or more units of government, each of which possesses independent budgetary and regulatory authority. This federal arrangement of governments is typically conveyed by the presence of central, provincial, and local governments within the same national territory. This arrangement is typically described as involving competition among governments (Breton, 1996). The association of federalism with competition among governments can surely be attributed in significant respect to Charles Tiebout (1956). Tiebout's framework, to be sure, was not expressly federal and rather involved competition

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* Eusepi: Dept. of Law and Economics of Productive Activities, Sapienza University of Rome, Via del Castro Laurenziano, 9, 00161 Roma Italy, Giuseppe.Eusepi@uniroma1.it. Wagner: Dept. of Economics, 3G4, George Mason University, Fairfax, VA 22030 USA, rwagner@gmu.edu.

among local governments within a metropolitan area. Still, this paper is widely cited as the archetype of a competitive system of governments. Federalism is also typically described as a decentralized form of government, as illustrated by Wallace Oates' (1972:31-63) articulation of a Decentralization Theorem, where it is claimed that under certain conditions a central-local arrangement of governments will be Pareto-superior to a central government standing alone.

Competition and decentralization, however, are not identical; competition describes an institutionally-structured process while decentralization describes a particular outcome of a process that itself may be either open to competition or closed to it. Competitive processes will often generate decentralized outcomes, but a decentralized outcome does not imply the presence of a competitive process. A competitive process entails a polycentric arrangement of competitors (Polanyi, 1951). In contrast, decentralization can be a product of monocentric authority wherein some ruling power chooses to establish some hierarchical arrangement that grants some measure of autonomy to lower levels in the arrangement, and with that autonomy subject always to amendment from the higher level. Within a polycentric arrangement of competitors, there is no locus of control over the arrangement. In contrast, decentralization is a monocentric arrangement that involves a locus of control. Hierarchical arrangements are inherently non-competitive because an order of precedence is built into the hierarchy. To treat federalism as a form of genuine competition among governments requires a polycentric arrangement among competitors, where the domain of any particular competitor is determined through a competitive process and not by some particular locus of authority. To treat federalism as a method for decentralizing governments leads to a spurious form of federalism that allows hierarchy to trump genuinely competitive federalism.

The literature on federalism has not given sufficient attention to some foundational questions that lie deep beneath the visible surface with which that literature has been concerned. On the surface, federalism seems to concern the boundaries of governments and the assignment of activities among those governments. Federalism thus pertains to a situation where a national territory contains numerous smaller jurisdictions, and with the national government undertaking some activities and those smaller governments undertaking other activities, and also with the national government offering grants to support some activities sponsored by lower governments. Within this literature, the central questions of analytical interest concern the drawing of jurisdictional boundaries, the assignment of activities and functions among those jurisdictions, fiscal issues concerning taxes and transfers, and with externalities being salient in all of these particular issues.

This common orientation reflects a monocentric approach to federalism, wherein a global allocation problem is solved analytically and with the various paraphernalia of federalism falling out of that analytical solution. By paraphernalia, we mean such things as the assignment of functions among jurisdictions, the allocation of tax bases among governments, and the place of intergovernmental grants. A conceptual home in the welfare economics of optimal resource allocation and systemic planning leads to notions of an optimal construction of geographic boundaries and assignment of functions among jurisdictions. The logic supporting political interventionism hinges upon an alleged superiority of centralized knowledge as compared with “dispersed knowledge” operating in the market. The most important inference deriving from this hypothesis is that competition can be justified only within the limits of “dispersed knowledge,” never with centralized knowledge. When knowledge is centralized, competition gives rise to a non-creative destruction, and therefore it should be cancelled from the public economy scenario.

To the extent that multi-level governments result from centralized knowledge and do not derive from “dispersed knowledge,” they cannot be considered to be many governments, but as parts of a monocentric government. It is self-evident that competition among parts of a single body is senseless. Not only is it unreasonable for a monocentric government to introduce competition, but it is just as unreasonable to introduce fiscal competition since it would give rise to a non-creative destruction.

In contrast, we explore a polycentric approach to competitive federalism, for genuine competition requires a polycentric arrangement among potential competitors, which clashes with the hierarchy implied in the assignment of functions among governments. The conceptual home for this alternative orientation lies in theories of emergent institutional processes, where the analytical focus is placed on processes by which the observed maps of jurisdictions and functions is subject to continual change through market-like processes within the public sphere, as illustrated by Ostrom (1991) and Wagner (2001).

2. FEDERALIST PLANNING: THE PREFERENCE-COST-EXTERNALITY NEXUS

The orthodox literature treats federalism within the equilibrium framework of efficiency in resource allocation. Thus functions are assigned among governments so as to secure Pareto efficiency. This analytical framework leads almost directly to a treatment of federalism as decentralization because it presumes that the knowledge necessary to secure allocative efficiency is possessed at the central level. In other words, allocative efficiency is not a

working property of an institutional framework that is openly competitive but rather is something that can be determined independently of any institutional framework. Hence, federal government is a creature of planning, or at least is subject to perfection through planning, where the extent of decentralization depends on conditions regarding preferences, costs, and externalities. This branch of federalist literature has sought to create some space for federal forms of government in the presence of a default presumption in favor of a unitized government. This literature has proceeded through a series of analytical exercises surrounding postulated differences in preferences, in costs of providing services, and in externality relationships among governments.

If there are geographically-related differences in preferences for collective activities, decentralization can allow a finer accommodation of individual preferences than could centralization. To illustrate this point, suppose a national government contains 200 people (add as many zeros as you wish if you would like the numbers to seem more realistic) and that this government provides public parks. The question at issue is how the parks should be designed. One option is for the parks to be configured with courts for handball and racquetball, and this option is preferred by 110 people. The other option is for the parks to be configured with bocce courts and picnic tables, with this option preferred by 90 people. If a referendum were held on which type of park to provide, handball and racquetball would win and 90 people would fail to have their preference satisfied.

As compared with national provision, decentralization is likely to increase the extent of preference satisfaction and will never lower it. So long as the distribution of preferences among citizens has some territorial variation, decentralization will increase the extent of preference satisfaction. For instance, suppose 80 of the 110 people who prefer handball and racquetball reside on the eastern side of a river that bisects the nation while 70 of the 90 people who prefer bocce and picnics live on the western side. If the provision of parks were decentralized by the creation of two public entities bordered by the river, the extent of preference satisfaction would rise from 110 to 150.² Only if there were no geographical variation in the distribution of preferences would decentralization fail to promote a finer accommodation of personal preferences regarding the configuration of parks.

Perfect accommodation of variation in preferences can, of course, be attained by removing parks from the domain of state activity. Yet cost savings through

² This example assumes the presence of collective provision, as against seeking to explain how collective provision might dominate market provision. Moreover, under the Wicksellian constitutional framework, only those who are satisfied would pay, so there would be no unsatisfied citizens. These kinds of issues point toward the alternative, polycentric orientation toward federalism that we will consider momentarily.

joint production plausibly render parks a type of club good that might be organized collectively, as explained initially by Buchanan (1965) and elaborated extensively in Cornes and Sandler (1985). Such economies of joint supply have often been construed as creating some limit to the degree of decentralization. For instance, suppose a nation contains one million residents and that economies of joint production are fully exploited when the size of a park-club is 100,000 residents. Such economies of scale would seem to suggest that decentralization should extend at most to ten jurisdictions. Indeed, such cost claims are often used to promote consolidation of jurisdictions. For instance, the presence of 20 jurisdictions under these circumstances would provide a basis for consolidation to secure the postulated economies of scale.

Yet there is no need for consolidation in this situation. As Bish and Ostrom (1973) explain, smaller jurisdictions can contract with other jurisdictions to provide services, thus allowing the capture of economies of joint production. A jurisdiction with 20,000 residents can provide a park that serves four other towns, each of which also has 20,000 residents. This allows five jurisdictions with 20,000 residents each to achieve the same economies of joint supply as could be achieved by a jurisdiction with 100,000 residents. There is no need for governments to consolidate to achieve those economies, as contracting is another option for achieving the same outcome. This is an option, moreover, that is widely practiced in the United States, as Bish and Ostrom show, where in some cases there are cities that secure nearly all of their public services through contracts with other governments.

Perhaps the dominant strand in the literature that treats federalism as synonymous with decentralization involves claims about externalities among jurisdictions. In this vein, Mancur Olson (1969) defines perfect mapping as a situation where the boundaries of a jurisdiction coincide with the set of users of services supplied by that jurisdiction. Oates' (1972) statement of his Decentralization Theorem is expressly based on a state of perfect mapping. Such perfect mapping is generally recognized as being exceptional and not common. This recognition brings all of the paraphernalia of market-failure theorizing into the literature on federalism. The Pigouvian domination of this literature has brought forth a host of suggested corrective measures to deal with those presumed failures of decentralization. Among these measures are governmental consolidation, tax harmonization, fiscal equalization, and conditional grants.

For instance, we may plausibly presume that in providing parks, individual jurisdictions will operate with decision processes that do not take into account the interests of residents of other jurisdictions who nonetheless might make some use of parks in other jurisdictions. We can describe each jurisdiction as conforming to a decision calculus in which the marginal benefit to residents

from additional park provision equals the marginal cost. Excluded from this calculus are the marginal benefits received by residents of other jurisdictions who nonetheless sometimes use parks provided by the jurisdiction in question. According to the standard efficiency conditions, there may be under-provision of parks by all jurisdictions. The provision by a higher jurisdiction of conditional grants for parks can restore efficiency in the supply of parks.

Notice, however, that what has been accomplished through this analytical construction is the insertion of hierarchy into the federalist arrangement of governments. We no longer have a polycentric arrangement of governments wherein the amount and configuration of park services is generated through open competition among governments. Instead, we have a hierarchically supervised decentralization where ultimate responsibility for systemic performance resides at the apex of that hierarchy. This is how it goes with Pigouvian-style formulations. Yet as Coase (1960) explained, there is always a contractual alternative to every Pigouvian claim; however, to mention this possibility gets into the constitutional and institutional matters to which we now turn.

3. MONOCENTRICITY, POLYCENTRICITY, AND GENUINE VS. SPURIOUS FEDERALISM

The common approach to federalism, with its stress on decentralization, construes a system of government in monocentric fashion. All governments are thus treated as divisions of the same organization. There is one organization, the state, which is decentralized into various branches and divisions. Just as it is possible to describe a corporation or an army as a hierarchical entity with one person at the head and with various subordinates responding to orders from above, so would a decentralized organization of government be described in the same manner, as illustrated by the common distinction that runs nation-province-locality. Lower levels of government in such a system may possess autonomy in their actions so long as conflicts don't arise with higher levels of government, just as company commanders in an army might possess autonomy over their actions so long as conflicts don't arise with brigade or division commanders. In either case, however, within monocentric systems the higher level trumps the lower level in the presence of conflict between levels over desired actions.

When federalism is assimilated to decentralization, the coordination of activities among governments conforms to the image of a marching band. To be sure, bands can differ in the quality of performance: some bands may march in step and play in key, while others have trouble doing so. Still, the activities of the participants are coordinated by a conductor, with the efforts of the

individual participants being subject to redirection by the conductor whenever the conductor is dissatisfied by the band's performance. This image maps well into most of the literature on fiscal federalism. For instance, if it is thought that there is an insufficient supply of parks among lower levels of government, the higher level government as conductor of the system of governments can alter the supply through grants or other measures.

The alternative to a monocentric system of government is one that is polycentric, as explained in general by Michael Polanyi (1951) and examined for systems of government in particular by Vincent Ostrom (1997). Genuine federalism pertains to a polycentric arrangement of governments and their activities, and with that arrangement and pattern of activity being an emergent property of open competition among governments. In a polycentric system there are numerous individual entities each of which pursues individually-chosen objectives while mutually adjusting to other entities that are doing the same thing. An openly competitive market illustrates a polycentric system where individual participants have their own objectives, but continually adjust to the actions of other entities. A genuinely competitive federalism would exhibit the same qualities of open competition for activities and support, as explored in Wagner (2007:55-78). A crowd of spectators leaving a stadium illustrates a polycentric system of relationships. Each participant has individually-chosen ends while also having continually to adjust to the actions of other participants in the crowd. The crowd is generally orderly and coordinated, yet it has no conductor. This image of an orderly pedestrian crowd, in contrast to that of a marching band, sets before us the alternative, polycentric approach to federalism.

A competitive federalism requires that the various units of government comprise an order and not an organization. The ability of any particular unit of government to expand or contract is determined through open competition with other governments as well as with citizens generally and their market-based organizations, as illustrated by Frey and Eichenberger (1999). A competitive federalism would thus have similar properties to a system of competitive markets. Within such a system, a particular government would face competition from other governments as well as from market-based entities. We would expect such a system of government to reflect continual changes in the sizes and activities of governments, much as we observe continual change through time in the sizes of business firms and their ranges of activity. It remains to be seen whether a genuinely open and competitive federalism represents an analytical box that can be filled.

It is not easy to extend the notion of competition among local governments within a nation to the genuinely competitive organization of all governments within a nation. Such an extension would map into the notion of a competitive

federalism, but this extension must remain an empty analytical box unless institutional requisites for a competitive federalism can be established. In this respect, in a clash among some of the titans of economic theory in the early 20th century, J.H. Clapham (1922) argued that the categories of increasing and decreasing returns were empty analytical boxes that could be filled only on the blackboard but not in the world of practice.³ Our task here is to explore whether the notion of a competitive federalism is an analytical box that is capable of being filled. The literature on federalism slides readily between federalism as denoting competition among governments and federalism as denoting the decentralization of governmental activity. In such sliding, Clapham's query about whether an analytical box truly can be filled is evaded by presuming that federalism and decentralization refer to the same thing. We do not slide around Clapham's query but rather ask what would be involved institutionally in creating a genuinely competitive system of governments. Central to our effort is the distinction between genuine and spurious forms of federalism.

4. DISTINGUISHING RHETORIC FROM REALITY IN THE THEORY OF FEDERALISM

It would always be possible to transform a polycentric crowd of pedestrians into something resembling a monocentric cousin to a marching band. This could happen if the individual spectators were herded in tightly controlled fashion so that they lost their ability to choose such things as their direction of exit, the speed at which they moved, and the location where they left the crowd. It is doubtful that this particular mass of pedestrians would be confused for a marching band, but it would bear a family resemblance, only with their instruments missing. Much of the analytical paraphernalia of theories of fiscal federalism is pretty much the equivalent of turning a polycentric arrangement of spectators into one that is monocentrically arranged over some interval of motion. The reality of federalism may diverge from the rhetoric, even if that rhetoric reflects what we think is the bottom-up rhetoric suitable to genuine federalism. Due to such things as grants and harmonization requirements, the appearance of polycentricity in action might be deceptive or illusory, with the reality being a form of monocentricity.⁴

³ The other titans involved in this controversy were D.H. Robertson and A.C. Pigou.

⁴ Our claim here is the inverse of Paul Craig Roberts (1971) who argued that the Soviet Union was never the system of collectivist planning portrayed by the official rhetoric, and was rather an inefficiently organized polycentric system where the particular rules that governed relations among participants promoted rampant inefficiency.

To explore the degree of congruity between reality and rhetoric requires we leave the level of surface examination and dive deeply into actual practice and the institutional arrangements through which such practice proceeds. Genuine polycentricity is organized by mutual accommodation and adjustment among independent actors. The overall pattern of governmental activities would be governed by open competition among units of government, wherein the so-called assignment of functions would result not from some planner's assignment but rather would be an emergent outcome of open competition. This kind of competition would have close parallels with market competition, where often small firms compete successfully against large firms (with small and large being used here in place of higher and lower, recognizing that higher and lower are not terms that are suitable for polycentric relationships).

The degree to which a system of government is characterized by open competition is a constitutional matter regarding the relationship among governments and citizens. Within a polycentric framework, mutuality and not domination governs relationships among the various units within the federal system. A constitutional framework that exhibits polycentricity on the surface may nonetheless exhibit monocentricity in its underlying operation. Some constitutional frameworks for polycentricity may be fragile, thereby allowing deep-level monocentricity to emerge out of surface-level polycentricity. To the extent this is so, a higher level of government has stronger ability to exact conformity from lower levels of government than lower levels have of pushing back the presence of higher levels of government through demonstrations of competitive superiority. For instance, the configuration of park services may appear on the surface to reflect polycentrically-ordered competition. But if the central government can impose conditions on the characteristics of park services and can use grants financed by national taxes to alter the services supplied by other governments, surface-level polycentricity can mask an underlying monocentricity, as explained in Wagner (1971:34-59).

Indeed, within the framework of the standard literature it is hard to think of genuinely good reasons for federalism. Most significantly, externalities are only a problem in this literature because of spillovers across jurisdictions. If those jurisdictions were eliminated, those spillovers would also cease. A single jurisdiction obviously would not experience spillovers among jurisdictions. A single jurisdiction guided by benevolence, moreover, would aim to practice something like Wicksellian tax-pricing. Hence, situations would not arise where people paid taxes for services they did not value. Support for federalism based on claims of Tiebout-type competition miss the point in this respect because they take jurisdictions as given along with tax institutions, and so seek to achieve some matching of people and preferences among jurisdictions. With

Wicksellian-like benevolence, however, there is no point to Tiebout-like competition because people would never be faced with having to pay taxes to support services they don't want.

Something is missing from the Tiebout-type frameworks, and that something involves the recognition that benevolence is rare and not common when it comes to governments, and that the appearance of benevolence can be nurtured or suffocated depending on the institutional framework within which governments operate. In recognizing this, we can appreciate Adam Smith's reference to the benevolence of butchers and bakers. What holds for butchers and bakers surely holds for public officials as well. Governments will tend to provide services citizens desire at efficient prices if public officials operate within an institutional and constitutional framework that both possesses incentives whose strength varies directly with the extent to which this is accomplished and promotes the use of knowledge that is distributed among participants and is not in the possession of some central authority.

Despite the fact that real federalist systems are not the mirror image of the rhetoric about federalism, it is disingenuous to say that federalism and decentralization largely coincide. It is evident that if it were so, our distinction between monocentric organization and polycentric order would appear as a pure semantic distinction, which it is not. It is worthwhile to note that the decentralization approach is characterized by a persistent and ineliminable antinomy. While the aim of decentralization is to internalize externalities, this can be accomplished only through a monocentric government – which must in turn be global.⁵ It is characteristic of decentralization, which is a spurious federalism, to act according to a sequential two-stage scheme. Its first stage is the creation of a market, which brings with it the failures ascribed to externalities. This creation is followed by stage two, which is characterized by the entry of government into the scene with the aim of correcting market failures through benevolent despotism. It is almost impossible to think of this sequential scheme without conjuring up the threefold branches of budget of the Musgravian theory (Musgrave, 1959), and still earlier, of functional finance (Lerner, 1943), which, in a sense, is very much like the tuning fork for the band's conductor. Just as in a band, the unitary state must have a single conductor for it to work. Not all sequential models are such, but they have similar flaws. It is worth noting that the neoclassical model is also organized around a two-stage sequential scheme. Unlike the Keynesian model, however, the neoclassical model reaches market equilibrium automatically in the first stage with

⁵ This explains why the EU crisis and the current global crisis are associated with the absence of a European and global government respectively.

government entering the scene in the second stage with the goal of modifying that equilibrium, which means in turn that the initial stage was one of disequilibrium. Hence, *mutatis mutandis*, in both schemes market comes before the state and the difference lies in the fact that in the former government corrects market failures while in the latter it produces failures.

Both analytical schemes lack simultaneity in the actions of state and market. The best example of market and state acting simultaneously is to be found in the Italian school of public finance, especially, and above all, De Viti de Marco (1936:184-203), whose contribution is explored in Eusepi (1989, particularly Sections 5-6). The primacy that De Viti gave to simultaneity in the actions within state and market was the centerpiece of his contractarian solution for both the relationship between government and citizens and that among units of government. De Viti's logic is at the basis of our genuine federalism, as elaborated in Eusepi and Wagner (2010).

Although in the real world the bright line separating genuine federalism from simple decentralization becomes blurred if compared to the ideal federalism frosted with rhetoric, to say that the political-institutional setting is unimportant would be unacceptable. The difference between the monocentric approach and the polycentric approach is, we believe, of paramount importance. In the polycentric approach sequentiality is replaced by simultaneity. Shifting from a two-stage model (first the market, then the state) to a one-stage model (market and state simultaneously) prevents governments from being considered corrective agents. They are rather enterprises – although with some peculiarities regarding prices most of all.⁶ This is certainly the case when considering intergovernmental competition. The polycentric order is the appropriate setting that legitimizes intergovernmental competitiveness. By contrast, the monocentric approach excludes competition by definition. Contrary to the polycentric approach, which associates tax competition with efficiency, the monocentric approach sees competition as an externality and identifies the way to internalize externalities in tax harmonization.⁷

Decentralization is not merely a pale imitation of federalism. It is much more. Decentralized governments give rise to interjurisdictional externalities, at both the intergenerational and intragenerational levels. By turning deficit into public debt, for which the central government is responsible, sub-central governments have incentives to run deficits as well. Hence, eliminating externalities via centralization must balance against social costs arising from the internalization process that the central government passes on to unspecified groups of taxpayers, especially losing

⁶ See De Viti de Marco (1936), Pantaleoni (1911), and Montemartini (1902).

⁷ The standard approach assumes that internalizing externalities does not involve additional costs. See Ellingsen, 1998.

minorities within majoritarian political processes. It is those minorities that in the end are required to bear the costs of centralization. The very existence of public debt, which is the less costly financing mode for the central government, shows that the so-called externalities of decentralization arise from a centralized decision that recalls the monocentric or marching-band approach.

All this suggests that it is the asymmetry between local government's spending power and central government's taxing power, and not decentralization, that gives rise to externalities. This means that not only is it impossible for externalities to be cancelled, it is just as impossible for them to be reduced through a centralization process; decentralization being a sly manifestation of the monocentric government. Therefore, claiming to eliminate fiscal externalities through centralization is equivalent to neglecting the additional internalities that the central government and its centralized bureaucracy give rise to in the name of eliminating externalities. More than that, transfers are apt to increase externalities rather than smoothing the inequalities generated by the difference in endowments among the different jurisdictions. Without fresh attempts to eliminate the discretionary power of the central government in allocating transfers, the centralization/decentralization operation is apt to increase rather than reduce externalities.

5. SOME INSTITUTIONAL AND CONSTITUTIONAL REQUISITES FOR GENUINE FEDERALISM

It is a mistake to think that the economic theory of markets makes it possible for an analyst to compute competitive equilibria outside the operation of actual market processes. Economists can use economic theory to describe notions of efficient allocations of resources, but there is nothing in economic theory that allows an economist to actually compute such allocations, because the knowledge that would be required to determine such allocations is distributed among many people and is not available to any single person. Rather than serving as a tool of resource administration, economic theory offers predictions about the consequences of institutional arrangements. Among other things, it offers the prediction that within an institutional arrangement of open competition, allocative outcomes will tend toward Pareto efficiency. The analytical focus is appropriately on institutional arrangements and only derivatively on resource allocations, as Nathan Rosenberg (1960) explains.

As for the nature of such a competitive order of activity, Walter Eucken (1952) expressed the central point succinctly when he noted that a competitive order was based on the private law principles of private property, freedom of contract,

and liability for damages ensuing from violations of property and contract.⁸ A competitive order is a network of enterprises and their plans of action. To be successful, an enterprise must fashion appropriate connections with both customers and suppliers of inputs, and in an environment where all such plans operate according to the principles of property, contract, and liability. What this means is that there is no single person whose permission is necessary for an enterprise to operate. While successful operation will require voluntary participation from input suppliers and from customers, there is no particular, identifiable person whose participation must be secured. This is what is meant by competition being free and open, or of having a polycentric arrangement. In contrast, a monocentric arrangement means that there are some particular persons whose permission must be secured before an enterprise can operate.

Within the bottom-up framework of genuine federalism, relations defined across pre-assigned territories move into the background as the analytical foreground comes to involve relationships among individuals and the governments they may create or extinguish. Market processes involve continual reassignments of activities among firms along with continual changes in the boundaries of firms. We can ask what a constitutional federalism would look like if the emergent assignment of functions (as distinct from some planner's assignment) were to be similar to the openly competitive form by which Toyota acquired more functions than General Motors or Google acquired more functions than Netscape. The first thing to be said about this is that no person or office made that assignment. Rather, that assignment emerged through an openly competitive process among firms who were seeking customers and customers who had the right to choose what to buy. In contrast to the literature on fiscal equivalence, equivalence would be defined in terms of relations between persons and governments and not between pre-established governments and territories (Eusepi, 2000).

To do this, however, brings questions of contract and duress into the analytical foreground on two levels: citizen-government and government-government. One prominent line of thought treats governments as maximizing the utility of the median voter through electoral competition (Persson and Tabellini, 2000). There is no independent verification of such claims, and there is good reason for at least some measure of skepticism about those claims. For one thing, there are substantial institutional differences between competition in markets and in politics. In market competition buyers don't pay anything unless they buy something from one of the competitors; however, they can always choose to buy from none of them. With political competition, there can be no withholding

⁸ Kasper and Streit (1998) present a contemporary restatement of these central ideas regarding the institutional order of free and open competition.

of payment. Furthermore, market competition allows several varieties of a product to exist, whereas political competition allows only one.

The relationship between citizen and government will often involve what would be called duress when transferred to a market setting. To observe that a citizen supports one candidate over another does not warrant the claim that the citizen truly chose the program offered by that candidate. This claim would be warranted only if the citizen continued to support the candidate along with the taxes that would be required to support that candidate's program even if he could have avoided paying those taxes by refraining from supporting that candidate. The avoidance of duress could be assured only through unanimity, and it is even doubtful if unanimity could truly accomplish this. An old aphorism speaks of going along with some group action in order to get along with the members of that group, and this situation describes duress in the presence of unanimity.

A further source of duress enters when we examine relationships between governments from a contractual perspective. Grants in aid are an excellent example in this respect. A national government offers grants to lower governments, with receipt of those grants conditional upon complying with requirements stipulated by the national government. The government-to-government situation in this instance is the same as it was in the citizen-to-government situation above. The lower level of government operates under duress and not truly according to the principles of contract. Whether the lower government accepts or rejects the grant program and the conditions that accompany the program, citizens of the lower government pay taxes to support the program.

Genuine federalism would entail an extension of contractual principles, as distinct from the spurious form of federalism that fills so much of the contemporary literature. A genuine contractual relationship presupposes that the contracting governments are politically and morally equal. This contractual approach, and the moral equality that accompanies it, does not contain any semblance of hierarchy. Accordingly, qualifications such as 'lower,' 'higher,' 'superior,' and 'inferior' level of government must be repudiated because they make no sense. As mentioned, in the polycentric contractual approach there is no such role as that of a head of the system. There is simply an order based on many governments, each of which behaves as a political enterprise operating within some set of constitutional rules.

This brings us to a crucial step of our argument against decentralization. Decentralization-patterned federalism is seemingly based on contractual intergovernmental relationships. Actually, those relationships are far removed from being contractual. When the budget process is analyzed, it is clearly evident that these relationships are some combination of collusion and

coercion. Those relationships serve to undermine the received classical principle of sound finance of maintaining a balanced budget. It is from the acceptance of this principle that collusive relationships may turn into conflictual relationships. It is clear that the solution regarding how to solve conflicts is to shift from order to disorder through an uncontrollable growth of budget deficits. It is precisely under the camouflage of an alleged fiscal solidarity that governments handle deficits and the related financial disorder. This solidarity is spurious exactly because it is the result of a process that itself is spurious because it gives rise to systemic intergenerational externalities.

6. CONCLUSIONS

We have shown that the treatment of federalism in public finance is simple only at first glance, but that simplicity quickly turns complex and confusing upon closer examination. The distinction between unitary and federal forms of government is of crucial significance. For a unitary form, citizens are directly connected to only one government. Confusion arises when decentralization is treated as synonymous with federalism as we find in a large part of the literature on fiscal federalism. Separating monocentric from polycentric systems of government has allowed us to distinguish spurious from genuine federalism and to reconsider the market and state relationship in a different light. The standard tradition in public finance, with the exception of the Italian one, analyzes these relationships in a sequential mode, and it does so by surreptitiously introducing rhetoric and ideology. Depending on whether one accepts the neoclassical paradigm or the Keynesian paradigm, the failing agent may become either the market or the government.

By accepting the simultaneous approach, where market and government are processes and not agents, we both reject sequential models in favor of simultaneous models and analyze the relationships between market and politics in terms of competing enterprises. Federalism is thus an explicitly polycentric system that is characterized by thoroughgoing competition, both competition among governments and between governments and market-based enterprises. Return to our earlier illustrations in terms of parks, there can be open competition among governments to supply park services as well as competition between governments and market-based enterprises to supply park services. This entire competitive process would possess a polycentric arrangement among participants where there is no locus of authority that can dictate to other participants in this process. We call spurious the federalism that is based on monocentricity, where decentralization and re-centralization are expedients to solve externalities from a central-government viewpoint.

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