FISCAL DECENTRALIZATION
A Political Theory with Latin American Cases

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ONE of the most important political developments of recent decades is the widespread move toward greater decentralization of government. Given the high level of centralization under communist rule, decentralization has naturally been a feature of postsocialist systems and has played an extraordinarily important but very different role in the two largest transition economies, Russia and China.[1] Decentralization has also been a pronounced trend in many newly democratic countries in Latin America, Asia, and Africa.[2]

Much of the vast literature on federalism and decentralization in both political science and economics is informed by the theory of fiscal federalism, which identifies numerous advantages in transferring powers and responsibilities to lower levels of government.[3] Ideally, each public good and service should be provided by the jurisdiction that would most fully internalize its benefits and costs. For a number of goods and services, this jurisdiction is clearly smaller than the national

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[1] Some of the most important theorizing on the politics of decentralization has grown out of these two cases, including Susan Shirk, *The Political Logic of Economic Reform in China* (Berkeley: University of California Press, 1993); Gabriella Montinola, Yingyi Qian, and Barry R. Weingast, "Federalism, Chinese Style: The Political Basis for Economic Success in China," *World Politics* 48 (October 1995); and Daniel Treisman, *After the Deluge: Regional Crises and Political Consolidation in Russia* (Ann Arbor: University of Michigan Press, 1999).

[2] For an overview, see Teresa Ter-Minassian, ed., *Fiscal Federalism in Theory and Practice* (Washington, D.C.: International Monetary Fund, 1997). Out of the seventy-five developing and transitional countries with populations greater than five million, all but twelve claim to be in the process of effecting some form of transfer of political power to local units of government. See William Dillinger, *Decentralization and Its Implications for Urban Service Delivery,* Urban Management Programme Paper (Washington, D.C.: World Bank, 1994).

[3] Classic statements include Charles Tiebout, "A Pure Theory of Local Expenditures," *Journal of Political Economy* 64, no. 5 (1956); and Richard A. Musgrave, *The Theory of Public Finance: A Study of Public Economy* (New York: McGraw-Hill, 1959). See also Wallace E. Oates, "An Essay in Fiscal Federalism," *Journal of Economic Literature* 37 (September 1999).

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one. Since citizen preferences vary across jurisdictions, decentralization enhances welfare by more closely matching government output to local tastes and increasing efficiency both in providing government services and in raising revenue.

A second generation of literature, exemplified by Barry Weingast's work on "market-conforming federalism," focuses greater attention on the incentive effects of different intergovernmental arrangements.[4] Decentralization can foster policy innovation and economic growth by stimulating competition among jurisdictions. Decentralization can also solve credible commitment problems in the protection of property rights and mitigate threats of state predation and civil violence. Decentralization may also dampen intercommunal tensions in ethnically divided states.[5]

Virtually all of these claims are controversial and, as we will show, highly contingent on political institutions. However, the main weakness of the literature on decentralization is its almost exclusive, ultimately normative concern with the economic and political *effects* of decentralization. With some important exceptions,[6] much less attention has been paid to explaining the causes—*why* countries decentralize as they do.

We propose a positive theory of fiscal decentralization or what is known in public finance as the assignment problem: the devolution of policy responsibilities and taxing and spending powers to state and municipal governments. We measure the nature and extent of such decentralization by examining both the statutes and the actual shares of subnational governments in total government spending and revenues.

In virtually all decentralized systems, however, the functional responsibilities of lower levels of government are not fully financed by their own tax revenues. Revenue-sharing agreements and intergovernmental transfers from the center are therefore an important component

[4] Weingast, "The Economic Role of Political Institutions: Federalism, Markets and Economic Development," *Journal of Law, Economics and Organization* 11 (April 1995); Montinola, Qian, and Weingast (fn. 1); Sunita Parikh and Barry R. Weingast, "A Comparative Theory of Fiscal Federalism: India," *Virginia Law Review* 83 (October 1997); Hehui Jin, Yingyi Qian, and Barry R. Weingast, "Regional Decentralization and Fiscal Incentives: Federalism, Chinese Style," Working Paper (Hoover Institution, Stanford University, March 1999).

[5] Contrast Ruth Lapidoth, *Autonomy: Flexible Solutions to Ethnic Conflicts* (Washington, D.C.: United States Institute of Peace Press, 1996) with the skeptical view in David Lake and Donald Rothchild, "Political Decentralization and Civil War Settlements" (Manuscript, University of California, San Diego, 1999)

[6] Among these exceptions are Treisman (fn. 1); Robert P. Inman and Daniel L Rubinfeld, "The Political Economy of Federalism," in Dennis Mueller, ed., *Perspectives on Public Choice Theory* (New York: Cambridge University Press, 1997); and Ugo Panizza, "On the Determinants of Fiscal Centralization: Theory and Evidence," *Journal of Public Economics* 74, no. 1 (1999).

of intergovernmental fiscal relations.[7] Countries vary in the *share* of central-level revenues that are passed on to states and municipalities. Equally important are the *rules* governing such transfers and the extent of control exercised by the central government. In centralized systems the national government has substantial discretion over the amount transferred and its distribution across jurisdictions. Highly centralized governments also influence or even determine the uses to which funds are put. In decentralized systems, by contrast, the national government's hands are tied by fixed revenue-sharing formulas that determine how funds are distributed and allocated, thereby granting wider discretion to lower levels of government.[8]

Our theory focuses on the accountability of politicians operating at different levels of government: presidents, legislators, and governors. Several features of the political system can influence these lines of accountability, but a crucial one is the internal structure of political parties, as noted by William Riker over twenty-five years ago.[9] Stated most simply, if parties are more centralized, any bargaining over intergovernmental fiscal relations will favor the center and the fiscal structure of the state will be more centralized. Conversely, if party control is less centralized, the state's fiscal structure will also tend be more decentralized, other things being equal.

Our empirical analysis focuses on five large countries—Argentina, Brazil, Colombia, Mexico, and Venezuela—that have three levels of government enjoying some genuine autonomy.[10] Despite this constitutional similarity, these countries display striking differences in the design of intergovernmental fiscal relations. We first undertake an exercise in comparative statics, showing how these differences are correlated with variations in the pattern of control and accountability within po-

[7] Anwar Shah, *The Reform of Intergovernmental Fiscal Relations in Developing and Emerging Market Economies*, Policy and Research Series (Washington, D.C.: World Bank, 1994).

[8] We consider a high level of discretion in intergovernmental fiscal transfers to be an indicator of centralization for reasons we outline in more detail below. However, discretion may in fact provide subnational governments with bargaining leverage and open the door to moral hazard problems and blackmail. If the subnational government knows that the center has the discretion to provide bailouts, for example, then there are few incentives to control expenditure and borrowing. Moral hazard can in principle be limited by a no-bail-out rule, but the capacity to set such a rule is endogenous to politics. See Barry Eichengreen and Jurgen von Hagen, "Federalism, Fiscal Restraints and European Monetary Union," *American Economic Review* 86, no. 2 (1996).

[9] Riker, "Federalism," in Fred Greenstein and Nelson Polsby, eds., *Handbook of Political Science*, vol. 5 (Reading, Mass.: Addison-Wesley, 1975).

[10] Four of the five countries in this category have federal constitutions; Colombia is the exception. For a more detailed review of political arrangements in the region, see Eliza Willis, Christopher da C. B. Garman, and Stephan Haggard, "The Politics of Decentralization in Latin America," *Latin American Research Review* 34, no. 1 (1999).

litical parties. We then use case studies to show the proposed causal linkages more convincingly and to demonstrate some dynamic implications of the theory. In particular, we show how growth in the political influence of subnational politicians is subsequently reflected in fiscal practice through greater decentralization. We close by discussing the research agenda on fiscal federalism, as well as some policy issues, including why the design of decentralization has so frequently fallen short of its promise.

I

We begin with the political concerns of national and subnational executives, focusing for the sake of simplicity on governors and ignoring municipal governments. Imagine an extremely simple democratic system in which there are two independent levels of government. A president (elected by all citizens) heads the national level and elected governors head the subnational ones—call them states.[11] At any given time there is an institutional status quo: rules govern how policy, spending, and taxing powers are distributed between the levels of government, and there are intergovernmental fiscal transfers that in theory can go in either direction.

Under what circumstances might the prevailing equilibrium be opened for renegotiation? Technological changes (or raising taxes) could affect the minimum efficient scale of public goods provision. This, in turn, might alter political actors' preferences. Alternatively, the demand for various public goods may shift due to changes in economic openness and integration.[12] Our Latin American cases reveal that fiscal crises play an important role in upsetting existing fiscal bargains, particularly when the effects of a crisis are uneven across jurisdictions. Broader political developments also create pressures for decentralization. This is most obvious in the case of civil wars and successful nationalist or secessionist movements. But democratization, too, creates such pressures, as democratic forces press for the extension of democratic rule to subnational jurisdictions.

[11] We will also put aside for the moment analysis of unitary systems without subnational jurisdictions (to our knowledge no such cases exist) or in which the executives of the subnational jurisdictions are appointed by the center (a quite common form, particularly in authoritarian regimes). However, the political dynamics outlined here are easily extended to such systems.

[12] For a review of the related literature, see Patrick Bolton, Gerard Roland, and Enrico Spolaore, "Economic Theories of the Break-up and Integration of Nations," *European Economic Review* 40 (April 1996).

Regardless of the specific source of pressure for decentralization, a new status quo will result from the bargaining process among politicians at different levels of government. We therefore need to know about the *preferences* of the relevant actors, their *capabilities,* and the *institutional setting* in which intergovernmental fiscal relations are negotiated.

Presidential preferences regarding fiscal decentralization exhibit two conflicting tendencies. On the one hand, with her national constituency, the president can claim credit for any efficiency gains in the provision of public goods associated with moving toward the optimal level of decentralization. Indeed, our cases confirm that executives often initiate decentralizing initiatives.[13] But on the other hand, any political gains the president reaps from such increases in efficiency can be offset by the loss of control over resources and by principal-agent problems.

The president will want to control resources, for two reasons. First, centralized control over resources permits presidents to equalize the distribution of goods and services across the country on the basis of need. Such equalization is central to government's classic redistributive function. But centralized control also allows presidents to allocate resources for purely political ends: to win elections and to control and maintain parties and legislative coalitions.[14] A second factor in transferring expenditure responsibilities, budgetary resources, or even taxing powers to lower levels is concern for the ensuing principal-agent and contracting problems.[15] If the president transfers functions and powers to a lower level of government, how can she be assured that her objectives will be carried out? In principle, contracts can be written to require that governors act in accordance with the wishes of the center. But for well-known reasons, including important informational asymmetries, such contracts often prove incomplete and difficult to monitor.

In sum, while presidents can gain from decentralization, these gains are partly offset by political and agency losses. Thus, we would expect the president to be more inclined to transfer responsibilities than the resources to meet them. In addition, she is more likely to prefer that expanded responsibilities be financed through local taxes rather than

[13] We will assume for the sake of argument that the status quo is "overcentralized" compared to the optimum, although the opposite can also be the case, as with Brazil.

[14] For empirical evidence of such behavior, see Juan Molinar Horcasitas and Jeffrey A. Weldon, "Electoral Determinants and Consequences of National Solidarity," in Wayne Cornelius, Ann L. Craig, and Jonathan Fox, eds., *Transforming State-Society Relations in Mexico: The National Solidarity Strategy* (San Diego, Calif.: Center for U.S.-Mexican Studies, 1994); Treisman (fn. 1); Moritz Kraemer, "Intergovernmental Transfers and Political Representation: Empirical Evidence from Argentina, Brazil and Mexico" (Washington, D.C.: Inter-American Development Bank, 1997).

[15] Paul Seabright, "Accountability and Decentralization in Government: An Incomplete Contracts Model," *European Economic Review* 40 (January 1996).

through transfers. Where transfers do exist, we expect the president to seek to control the uses to which funds are put in order to reduce agency loss; this can be done through devices such as earmarking and matching grants.[16] At the extreme we can imagine a predatory president who seeks to control all fiscal resources and to maintain complete discretion over how they are used.

What are governors' interests in this renegotiation? Of course, each governor would prefer to receive a net transfer from the center, rather than having to raise taxes, particularly if he can also retain discretion over the use of such transfers. At the extreme, we can imagine a governor who is the mirror image of a predatory president: a pure looter who shuns all responsibilities and seeks to maximize his take from the center and ultimately from the other states. However, "responsible" governors can also benefit from decentralization when state governments have both adequate resources, whether through local taxes or transfers, and a comparative advantage in providing the services assigned to them. With respect to transfers, we would expect governors to place higher estimates on their resource needs than the president, not simply because of the superiority of local information but for strategic reasons as well. Governors will also be more concerned about the *certainty* of receiving transfers and the *conditions* attached to them. Governors should favor fixed formulas for the amount and distribution of resources across jurisdictions and greater discretion in their use. In sum, governors should seek to restrict presidential control while expanding their own.

II

Given these partly overlapping, partly conflicting preferences, what determines the outcome of intergovernmental fiscal bargaining? If governors and presidents were the only actors, then the political lines of accountability between them would constitute an important factor. We can see why this would be so by introducing political parties into our simple constitutional setup. In a situation of "vertically divided government," when the governor and the president are from opposing parties, the divergence of preferences outlined above becomes even more pronounced.[17] The president might be willing to transfer some func-

[16] This assumption is subject to the important caveat in fn. 8.

[17] The ordinal preference ranking among different outcomes (for example, centralized, decentralized with central control, decentralized without central control) remains the same, but the distance in absolute value between the respective preference value for each system increases.

tions to subnational governments, but she would be reluctant to transfer resources to opponents and would face even greater difficulties in controlling subnational behavior. Conversely, governors would find central control over resources even more objectionable and would seek to tie the president's hands through fixed formulas.[18]

If the president and governor are from the same party, the distribution of powers and resources will depend on the nature of their political relationship. Imagine two extremes. In one case the party is purely hierarchical: the president nominates governors and determines their careers through control over nominations, campaign finance, and appointments to nonelective offices. In this case we would expect governors' preferences to align closely with the president's. The system would tend toward greater centralization, and any renegotiation would favor the president's interest in controlling the extent and nature of fiscal decentralization. By contrast, imagine an assembly of governors that controls the nomination of the president. Here, we would expect presidential preferences to align more closely with those of governors, leading to more decentralization.[19]

Typically, however, bargaining between presidents and governors does not occur in such a direct and unmediated fashion. Any significant changes concerning the functional reassignment of spending and taxing responsibilities between levels of government usually require legislation or even constitutional revision. The bargaining game is therefore played out within the national or constituent assembly, thus making the interests of legislators an important determinant of which preferences prevail—presidential or gubernatorial.

As with presidents and governors, the interests of legislators depend in part on the partisan composition of the government. Under divided government, legislators will be attentive to checking the powers of the president, including her control of resources, and will seek to channel resources to their copartisans at the subnational level. If a single party controls both branches or the president relies on a majority coalition in the legislature, much will depend on the lines of authority and accountability within the ruling party or parties. Where parties are disciplined and legislators are responsive to the president and national party leadership (or leaderships in the case of coalitions), we would expect

[18] Uncertainty about transfers from the center might also lead opposition governors to raise their own revenues by taxation.

[19] For the purpose of this argument, we are assuming the existence of a median governor. In fact, governors may have different preferences depending on the wealth of their state and access to locally generated tax revenues.

outcomes closer to the president's preferences. However, if legislators are dependent on governors to advance their political careers, they will naturally seek to curry favor with them, including through the design of intergovernmental fiscal relations.

Several features of the political system influence whether lines of authority and accountability within parties push legislative preferences closer to the presidential ideal points or closer to the gubernatorial ones. These include electoral laws encouraging either party-centered or candidate-centered voting,[20] who has control over campaign finances, and the nature of career opportunities for politicians once they leave elective office.[21] While all of these factors may be relevant, we focus in the first instance on two easily measured proxies that capture the broad lines of authority and accountability within the party system. First, we consider who—the national party leadership (often the president) or subnational leaders—controls candidate nominations for national legislative office.[22] While party-nomination rules rarely give governors de jure control over candidate selection, their de facto influence is greatest when nominations occur at subnational party conventions. Other things being equal, therefore, we expect national-level control to be associated with more centralized outcomes and greater subnational influence, with greater decentralization.

Second, since the countries we analyze all rely on proportional representation (PR), we ask whether they employ a closed- or open-list system. Under closed-list PR systems, party leaders control not only the nomination rules (who may be a candidate) but also the rank order of candidates on the ballot. Because the party leadership determines the rank order of candidates and thus the order of their election, the voters' only option is to cast their vote for a particular party's list. As a result, the party leadership exerts substantial control over the rank and file because individual legislators are dependent upon party leaders for a favorable ranking in the next electoral cycle. Ceteris paribus, one could therefore expect closed-list PR systems to be associated with greater centralization.

[20] In the most comprehensive analysis of the issue Carey and Shugart identify four factors that determine these electoral incentives: party control over nominations; the existence of vote pooling; whether voters cast only a single vote for a party, multiple votes, or a single vote for a candidate; and district magnitude. J. M. Carey and M. S. Shugart, "Incentives to Cultivate a Personal Vote: A Rank Ordering of Electoral Formulas," *Electoral Studies* 14, no. 4 (1995).

[21] This last factor is emphasized by David Julian Samuels, "Careerism and Its Consequences: Federalism, Elections, and Policy-Making in Brazil" (Ph.D. diss., University of California, San Diego, 1998).

[22] In some countries nomination procedures vary according to political party, but in our coding we have sought the central tendency across parties.

Legislative preferences in closed-list PR systems, however, will be greatly affected by *which* party leaders control the ordering of the party list. Thus, legislative preferences will more closely align with presidential ones if national party leaders have control over party lists. And alternatively, legislative preferences should align more closely with gubernatorial interests in systems where state-level party leaders control the rank order of candidates on the party lists in their jurisdictions.[23]

In systems with open-list PR, by contrast, party leaders do not control the ordering of candidates on the list.[24] Rather, voters make that determination by casting their votes for individual candidates. Candidates compete not only against other parties but also against members within their own party. Consequently, open-list PR systems encourage candidates to develop a personal reputation in order to win votes.[25] There are a number of strategies by which candidates can build a personal reputation, but a common one is to make political alliances with state and local executives who can deliver the vote. In systems where such a strategy is commonplace—as in Brazil—subnational executives gain even greater influence over legislators. Since candidates must develop a personal reputation in order to win votes, subnational executives can make alliances with national legislators *even across party lines*. Subnational party leaders in closed-list PR systems, by contrast, can wield influence only over candidates within their own party.

Table 1 compares Argentina, Brazil, Colombia, Mexico, and Venezuela on these two measures at the time that major decentralizing initiatives were launched in each country. Brazil and Colombia are the most decentralized of the five countries on these two indicators, with Argentina also exhibiting signs of substantial subnational influence: al-

[23] Such an influence arguably presumes that electoral districts mirror subnational boundaries. That assumption remains valid for most of the cases examined here; there are some exceptions, however. In Colombia members of both the lower and upper houses were elected in electoral districts that were coterminous with subnational political units prior to 1991. As a result of constitutional changes in 1991, however, the upper house is now elected in a single national district. In Mexico three-fifths of the lower house is elected in districts that are not coterminous with lower administrative units. In Venezuela electoral districts mirrored subnational boundaries prior to 1993, but subsequent to a 1993 reform half of the lower house has been elected in districts that are not coterminous with subnational boundaries. However, even where the overlap between electoral and subnational districts is not perfect, it is still plausible that subnational politicians could influence legislative behavior.

[24] Despite this effect of the electoral system, we have kept nomination rules within parties as one of our two indicators precisely because it is an *indicator* of party organization and lines of accountability within parties, rather than a determinant of it. Even in open-list PR systems like Brazil, where party leaders exert relatively little influence over party members in comparison with Venezuela's closed-list system, decentralized nomination rules provide an important indicator of the relative influence wielded by subnational politicians.

[25] Carey and Shugart (fn. 20).

Table 1
Nomination Control and List System

Country	*Nomination Control*	*Electoral System*
Argentina	subnational: both principal parties (PJ and UCR) use internal primaries for assembly elections at the provincial level	closed list/mixed control: provincial party leaders determine the rank order of the party list, but national party leaders can intervene in provincial party organization or put the alternative national party list to a vote with provincial list determined by rank and file
Brazil	subnational: all parties hold municipal, state, and national conventions, with each level nominating delegates to its superior convention; state conventions nominate candidates for congressional and senate races, and national conventions nominate candidates only for presidential contests; governors exert substantial influence in state conventions	open list/subnational coalitions: candidates employ personal vote strategies through making political alliances with subnational executives
Colombia	subnational: nominations occur at the district level	multiple closed list/subnational control: voters choose among closed-party list, but each party can propose multiple lists at the district level; order of district-level party lists is determined by regional party bosses; national party leadership exerts no influence
Venezuela	mixed/national dominant: state-level leaders submit an initial list of candidates to the national party leadership, but national leaders have veto power over the candidates selected and can replace half the submitted list with their own candidates	closed list/national control: within the AD state-level leaders submit unranked lists to national party leadership which must contain three times the permissible number of candidates; national leadership can replace half the submitted list with its own candidates
Mexico	national: for PRI, historically highly centralized in party leadership and president. Party leadership also important in PRD and PAN, but with some use of conventions (PAN) and primaries (PRD) emerging	closed list/national control

though the party controls closed lists, provincial-level party organizations have influence over nominations. Venezuela and particularly Mexico, with its quasi-authoritarian party-dominant system, are clearly the most centralized. As we show in the next two sections, these broad differences in level of political centralization correlate closely with the overall *level* of fiscal decentralization. More importantly, they help to explain differences in the *speed* and *extent* of the decentralization process over the last two decades as well.

III

Capturing the extent and nature of fiscal decentralization requires considering the allocation and control over taxing, spending, and revenues across jurisdictions.[26] We begin by examining the distribution of formal powers and actual spending and taxation across jurisidictions. Table 2 draws on data on the delineation of expenditure responsibilities in several functional areas.[27] Argentina clearly stands at one end of the spectrum, with only one of fifteen services—universities—held exclusively in national hands and over 50 percent of most functional responsibilities assigned exclusively to the subnational level. Brazil and Colombia are broadly similar, although with greater oversight at the national level in Colombia. Mexico and Venezuela are more centralized, with more powers exclusively national and fewer exclusively subnational. As in Colombia, and in contrast to Argentina and Brazil, oversight in these two countries is concentrated at the national level.

Table 3 summarizes the distribution of revenue and spending across levels of government. The data are of varied and uneven quality and cannot by themselves be taken as reliable indicators of the level of decentralization; the rules governing the use of resources are equally if not more important in understanding intergovernmental fiscal relations. Nonetheless, the data do suggest some order-of-magnitude differences across the cases. On the revenue side, Mexico and Venezuela stand out as the most centralized systems, with virtually all taxing powers historically concentrated in the hands of the central government. Even *after* fiscal reforms were introduced, the national government of Venezuela continued to collect over 95 percent of total tax revenue. This was due to its high dependence on revenues from the state oil company. In

[26] Weingast (fn. 4).

[27] These data are drawn from Inter-American Development Bank, *Latin America after a Decade of Reforms: Economic and Social Progress in Latin America, 1997 Report* (Washington, D.C.: Inter-American Development Bank, 1997), 196–97.

TABLE 2
DELINEATION OF EXPENDITURE ASSIGNMENTS BY FUNCTION[a]

	Exclusively National (%)	*Exclusively Subnational (%)*	*Mixed (%)*
Argentina			
amount	13	60	27
structure	6	67	27
execution	6	67	27
supervision	37	42	21
Brazil			
amount	20	30	50
structure	20	30	50
execution	20	30	50
supervision	45	20	35
Colombia			
amount	25	20	55
structure	30	25	45
execution	20	30	50
supervision	80	15	5
Mexico			
amount	45	10	45
structure	25	20	55
execution	30	35	35
supervision	70	20	10
Venezuela			
amount	37	16	47
structure	37	16	47
execution	32	16	52
supervision	84	16	5

SOURCE: Inter-American Development Bank, *Latin America after a Decade of Reforms: Economic and Social Progress in Latin America, 1997 Report* (Washington, D.C.: Inter-American Development Bank, 1997), 196–97.

[a] The categories indicate which level of government decides the *amount* spent, the *structure* of expenditure, the *execution* of expenditure, and the *supervision* and setting of standards. For Brazil, Colombia, and Mexico the survey covers twenty policy areas, for Venezuela nineteen, and for Argentina fifteen.

Mexico the federal government continued to dominate tax collection into the mid-1990s. Moreover, such increases in subnational taxing power as we do see were not matched by increases in control over expenditure, suggesting that the center had effectively forced subnational governments to increase their tax effort.[28] Argentina and Colombia are

[28] Because Mexican revenue data include transfers from other levels, these numbers overstate the level of decentralization. We explore this issue in more detail below.

TABLE 3
REVENUE AND SPENDING BY LEVEL OF GOVERNMENT
(BEFORE AND AFTER DECENTRALIZATION)

Country	*Share of Total Government Tax Revenue Collected by Level of Government*		*Percentage Change in Revenue*	*Share of Total Government Expenditure by Level of Government*		*Percentage Change in Expenditure*
Argentina	1983	1992		1980–84	1990–94	
central	79.3	80.0	+(0.9)	63	54	−(14.3)
subnational	20.7	20.0	−(3.3)	37	46	+(24.3)
Brazil	1975	1995		1980–84	1990–94	
central	73.7	66	−(10.4)	74	45	−(39.2)
subnational	26.3	34	+(29.2)	26	55	+(111.0)
Colombia	1980	1994		1980	1994	
central	82.2	80.1	−(2.7)	72.8	66	−(9.3)
subnational	17.8	19.9	+(11.8)	23.2	34	+(46.6)
Venezuela	1980	1989		1985	1997	
central	95.8	96.9	+(1.1)	84.5	73.9	−(12.3)
subnational	4.1	3.2	−(22.0)	15.6	26.1	+(64.1)
Mexico	1982	1994		1980–84	1990–94	
central	90.7	82.7	−(8.8)	81	71	−(12.3)
subnational	9.3	17.3	+(86.02)	19	29	+(52.6)

SOURCES: For expenditure shares: Argentina, Brazil, and Mexico, International Monetary Fund, *Government Financial Statistics* (Washington, D.C.: IMF, various issues); Venezuela, Michael Penfold-Becerra, "Institutional Electoral Incentives and Decentralization Outcomes: Comparing Colombia and Venezuela" (Ph.D. diss., Columbia University, 1999). For tax shares: Argentina, Daniel Artanta et al., "Chapter Two: Argentina," in Ricardo López Murphy, eds., *Fiscal Decentralization in Latin America* (Washington, D.C.; Inter-American Development Bank, 1995); Brazil, Fernando Rezende, "Federalismo Fiscal no Brasil," *Revista de Economica Política* 15 (June–September 1995); Venezuela, World Bank, *Venezuela: Decentralization and Fiscal Issues* (Washington, D.C.: LA1 Department, Infrastructure and Operations Division, 1992); Mexico, INEGI, *Anuario Estadistico de los Estados Unidos Mexicanos* (1994). Colombian data on both expenditures and taxation are from Interamerican Development Bank, "Fiscal Decentralization: The Search for Equity and Efficiency," in *Economic and Social Progress in Latin America, 1994 Report* (Washington, D.C.: Inter-American Development Bank, 1994).

more decentralized in this regard, and Brazil is the most decentralized of the five in taxing powers.[29]

Expenditure shares diverge substantially from the revenue pattern. In all cases, decentralizing reforms have had their most notable effect in the increased share of lower levels of government in total expenditure. However, comparisons across the cases again suggest interesting differences. The figures for Mexico overstate the extent of centralization by counting some transfers as federal expenditures; nonetheless, as we will see in more detail in the case study below, central control of these resources has remained substantial. Venezuela is also fairly centralized, followed by Colombia, which underwent a further shift in expenditure responsibilities to subnational governments after 1992. Argentina and particularly Brazil rank as the most decentralized in this regard. Both saw substantial shifts in the patterns of spending toward subnational governments in the 1980s.

The divergence between shares of revenue and expenditure underscores the importance of intergovernmental transfers. The extent of these transfers varies across our cases. Figure 1 presents the available data on transfers to lower levels of government as a share of total central government expenditures and lending net of repayments. Brazil's level of transfers appears relatively low, but in a context in which aggregate government spending is already highly decentralized. Moreover, it shows a clearly rising trend after 1988. Mexican and Venezuelan transfers are higher, with Venezuela's showing a rising trend after 1989. In contrast to Brazil, however, aggregate government spending in these two countries remains highly centralized. Argentina shows a huge spike during the early years of the administration of President Raúl Alfonsín (1983–89), followed by a substantial consolidation in 1988.[30] Colombia shows the highest level of transfers among our cases.

Political control between levels of government is not well captured by the assignment of policy responsibilities and taxes, the level of ex-

[29] Provincial governments in Argentina increased their share of total tax revenues from 13.7 percent in 1983 to 15.4 percent in 1992. This expansion came at the expense of local governments, which suffered a decline from 7 to 4.6 percent in the same period, while the share controlled by the federal government remained virtually unchanged. In Colombia, by contrast, local governments gained at the expense of departmental governments between 1980 and 1991. Again, the central government experienced only a small decrease in its share of revenue. Brazil was more decentralized with respect to taxing powers even prior to the transition to democratic rule, suggesting the importance of historical legacies. Between 1974 and 1988 states increased their share of total government tax revenue from 36.9 percent to 49.4 percent; the share controlled by local governments actually decreased slightly from 3.8 to 3.6 percent. However, Brazil is also the country that experienced the most significant *change* in taxing powers toward the state level after 1988 as well.

[30] As we explain below, this explosion of transfers was primarily the result of central bank payments to provincial banks that reflected a predictable political logic.

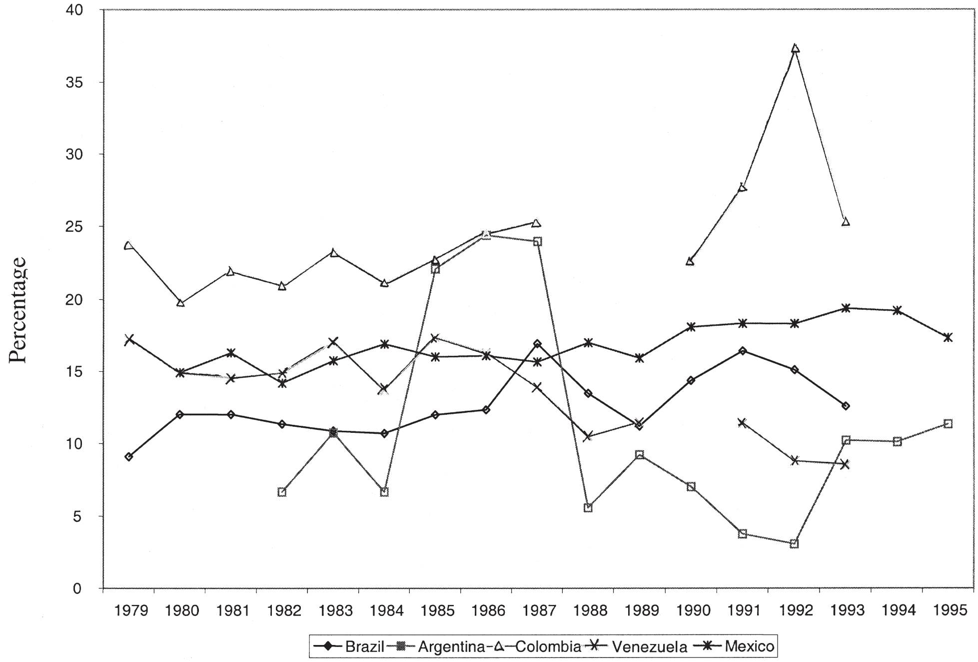

FIGURE 1

TRANSFERS TO OTHER LEVELS OF GOVERNMENT
(AS PERCENTAGE OF TOTAL CONSOLIDATED CENTRAL GOVERNMENT EXPENDITURE)

SOURCE: IMF Government Finance Statistics Yearbook (various issues). Figures for Mexico are total revenue sharing as percentage of federal government revenue.

penditures at different levels of government, or the extent of transfers. Rather, we must also look at the rules governing the use of resources: the control that central governments exercise over the *distribution* of resources and the *purposes* to which they can be put. We use three indicators to gauge such control. First, we have coded programs of intergovernmental transfers in the five cases according to whether they are automatic or discretionary in nature. We presume that automaticity is more likely to reflect the preferences of subnational governments eager to tie the executive's hands, while discretionary programs provide presidents with greater control.[31] Second, we have further divided au-

[31] Again, see the important reservation at fn. 8.

TABLE 4
CHARACTER OF INTERGOVERNMENTAL TRANSFERS
(PERCENTAGE)

Distribution:	*Automatic Constitutional*		*Automatic Legislated by Law*		*Discretionary*	
Assignment:	*Unconditional*	*Earmarked*	*Unconditional*	*Earmarked*	*Unconditional*	*Earmarked*
Brazil	88.91	5.6				5.48
Argentina	74.98	19.82			5.19	
Colombia		84.95				15.05
Venezuela	44.2	44.2	1.04	5.6	4.94	
Mexico			49.12			50.87

SOURCE: Inter-American Development Bank, *Latin America after a Decade of Reforms: Economic and Social Progress in Latin America, 1997 Report* (Washington, D.C.: Inter-American Development Bank, 1997).

tomatic transfers into those prescribed by the constitution versus those prescribed by ordinary law. We assume that constitutionally mandated transfers offer subnational officials greater security than do statutes. Third, we distinguish between programs extending unconditional transfers and those earmarking funds for particular purposes. While earmarking per se does not necessarily signal tight central control,[32] for the purpose of this initial comparison we associate it with greater centralization.

Table 4 shows that transfers in Brazil and Argentina cluster heavily in the automatic-constitutional category with little earmarking. Transfers in Colombia are also predominantly in this quadrant, although with greater earmarking. Venezuela deviates somewhat from expectations. It has a high level of constitutionally mandated transfers, but nearly half are earmarked. Again, the Mexican government exercises the most control, with just over half of all funds being both discretionary and earmarked.

One last measure of central government control over subnational finances concerns the rules governing subnational borrowing (Table 5). At first, no clear patterns appear. For example, both Venezuela (a more centralized country by other measures) and Brazil (a more decentralized one) require central government approval of subnational borrowing. Both Mexico (a more centralized country) and Argentina and

[32] For example, the high level of earmarked funds in the Colombian case reflects only the broad requirement that the funds be spent on salaries in the social sectors. Subnational governments may also evade earmarked requirements. By contrast, earmarking in Mexico often contains quite detailed stipulations regarding particular projects and close monitoring.

TABLE 5

BORROWING AUTONOMY IN LATIN AMERICA

	Borrowing by SNGs Not Allowed	*Central Govt. Approval Required on SNG Debt*	*Debt Cannot Be Used for Current Expenditures*	*Numerical Debt Limits in All or Most SNGs*	*SNGs Own Banks*	*There are Important SNG-Owned Firms with Liberal Borrowing Practices*	*Tax Sharing Used to Guarantee SNG Debt*
Brazil		X			X	X	X
Argentina			X	X	X	X	X
Colombia			X	X	X		X
Venezuela		X					
Mexico			X			X	X

SOURCE: Inter-American Development Bank, *Latin America after a Decade of Reforms: Economic and Social Progress in Latin America, 1997 Report* (Washington, D.C.: Inter-American Development Bank, 1997).

Colombia (apparently less so) restrict borrowing to financing current expenditures. One salient feature that does emerge, however—subnational governments in Brazil and Argentina have both banks and government-owned firms with "liberal borrowing practices." Acting as effective conduits for government borrowing, these banks and firms have given subnational governments considerable autonomy from central authorities; they also contributed to serious subnational debt crises in the 1990s.

As this discussion shows, there is no simple way to measure the extent and nature of fiscal decentralization; moreover, patterns change over time, as we will see in more detail in the next section. Nonetheless, *even when we control for the formal level of political decentralization*, the different measures converge on the following generalizations. Mexico is substantially more centralized than the other four countries. Brazil and Argentina stand out as the most decentralized. Venezuela and Colombia are arrayed in between, but with Venezuela more centralized and Colombia sitting closer to Argentina and Brazil and becoming more decentralized over time.

IV

The nature and extent of decentralization broadly correlates with the two political indicators outlined at the end of the last section, but the match is not perfect. Argentina, for example, is more decentralized with respect to the assignment of functions outlined in Table 2, despite the fact that party organization in Brazil is much weaker and more decentralized. In Venezuela party organization is relatively centralized, yet revenue sharing follows a pattern that appears to correspond with the interests of subnational governments. These and other anomalies may arise from measurement and coding errors. For example, we assume exclusive assignment of a high number of functions to subnational governments indicates a system where governors successfully lobbied for greater decentralization. However, it might represent instead the ability of the federal government to impose costly and unwanted fiscal responsibilities on lower levels of government. Similarly, mandated earmarking may or may not actually constrain subnational governments in practice. In politically decentralized systems earmarking may be circumvented by lax enforcement.

To isolate these coding problems and to capture differences in initial conditions, we undertake paired comparisons that try to hold constant some of the ultimate sources of pressure for decentralization. We first compare Colombia and Venezuela, then Brazil and Argentina, before making some brief observations about Mexico in comparative perspective.

These sketches also attempt to get at the dynamic nature of the decentralization process. The argument so far has been comparative; countries with party systems pulling legislators closer toward gubernatorial preferences will exhibit a greater level of decentralization than those with more "nationalized" party systems. Nevertheless, as these case studies show, the bargaining power of governors, presidents, and legislators over decentralization is not static. Political or economic crises, in which the basic decentralization process may or may not play a prominent role, can shift the relative power of politicians operating at different levels. Moreover, the very act of reassigning spending and taxing responsibilities between levels of government can itself influence politics, including lines of accountability within political parties; we return to this important endogeneity problem in the conclusion.

Colombia and Venezuela

Colombia and Venezuela yield an ideal country comparison because they share a number of features that distinguish them from the other three cases. First, the impetus for decentralization in both countries originated with the national executive and occurred in conjunction with the implementation of political decentralization, that is, the introduction of elections to subnational units. In each case the national executive proposed limited measures of fiscal decentralization and successfully opened direct elections for governor and mayors during the late 1980s. Both of these measures were implemented as a means to counter domestic political challenges to the president's party. Second, the impetus to decentralize in both countries came after a prolonged period of democratic rule in which two dominant parties alternated in power at the national level. Unlike other countries in Latin America where political decentralization has been associated with the transition to democracy, Colombia and Venezuela decentralized in response to public dissatisfaction with the existing party system.

Despite these similarities, the two countries differ on the extent to which they transferred revenue and spending powers. In Venezuela the legislature adopted a modest fiscal transfer to state and municipal governments with significant central control over its uses. In Colombia legislators adopted a more aggressive transfer of responsibilities, taxing, and spending powers to regional and municipal governments. Fiscal transfers were also much higher in Colombia, though characterized by substantial earmarking.

These divergent outcomes can be traced directly to the incentives facing legislators when these reforms were initiated. Political power in Venezuela has been highly centralized since the inception of democratic rule in 1961, with national party leaders within the two dominant parties (Acción Democrática and COPEI) wielding tremendous influence over their respective party members. Prior to 1993 voters chose between closed party lists, with the rank order of candidates for the national legislature determined by national party leaders. Throughout the period under consideration, elections for all offices were held concurrently, further reinforcing the national orientation of the congress.

Responding in 1984 to large public discontent, a fiscal crisis, and growing pressures from within his party, President Jaime Lusinchi (AD, 1984–89) created a reform commission whose recommendations paved the way for the introduction of direct elections for mayors and governors in 1989.[33] In the first legislative session following the introduction of direct elections, legislators gave state and municipal governments a greater share of federal revenue. The new law (Ley Orgánica de Delimitación y Tranferencia de Competencias, LODT) increased the state government share of federal taxes from 15 to 20 percent by 1994 and the municipal share from 10 to 20 percent by 1999.

But while transferring additional revenue to state and municipal governments, the law actually reinforced central control over subnational finances. The law not only stated explicitly that governors were "agents" of the president, but it also granted the senate authority to remove any governor by a two-thirds vote. The transfer of further revenue and any functional responsibilities could be initiated either by the president or by state governors, but such actions required approval by two-thirds of the congress and a simple majority in the state legislative assemblies. In practice, national legislators resisted gubernatorial requests to transfer public functions because of their desire to maintain tight control over the distribution of patronage at the subnational level and their close ties to centralized public sector unions that were active at the center.[34] Central control appeared complete; by 1992 not one function had been transferred to a state government.

[33] Comisíon Presidencial para la Reforma del Estado (COPRE). For an analysis of how the impetus to decentralize stemmed from declining popularity of the main political parties in Venezuela, see Vincente Fretes Cibils, "Venezuela: Diálogo para el desarrollo: La decentralización" (Manuscript, World Bank, 1999).

[34] Joachim Knoop, *Descentralización fiscal en Venezuela* (Santiago de Chile: Comisión Económica para América Latina y El Caribe, 1994). Much of the following discussion draws upon Michael Penfold-Becerra, "Institutional Electoral Incentives and Decentralization Outcomes: Comparing Colombia and Venezuela" (Ph.D. diss., Columbia University, 1999).

This resistance to decentralization began to break down following a series of political crises in 1992 and 1993, including two failed coup attempts and the impeachment of President Carlos Andrés Pérez. In the wake of these dramatic events, two major developments in the Venezuelan party system began to alter the bargaining relationship between central and subnational authorities. First, a dramatic decline in voter identification with the COPEI and AD challenged their duopoly, and in a short time Venezuela was transformed into a multiparty system. Second, the newly created Association of Venezuelan Governors pressed for changes in the electoral and party systems, including the election of 50 percent of deputies by plurality in the chamber. The governors clearly sought these reforms in order to make national legislators more accountable to regional interests. Simultaneously they sought a more rapid transfer of functions to the regional level that would follow a set timetable. While the rules for electing senators remained closed list, the new chamber elected in 1993 under these altered rules increased the transfer of revenues to states and municipalities and responded more favorably to several state requests for the decentralization of public services in the areas of education, health care, child care, agriculture, nutrition, and housing.

Venezuela's more timid and hesitant approach to decentralization stands in contrast to reforms enacted in Colombia. As in Venezuela, the congress in Colombia initially resisted all attempts to decentralize fiscal resources or administrative functions. However, their reasons for defending central control reflected substantial differences in the party and electoral systems in the two countries. Control over nominations, electoral rules, and the timing of elections made Colombian legislators more responsive to subnational interests. These interests took the form not of elected officials but of regional electoral machines headed by political bosses whose continued support depended on patronage from the legislature.

Much as in Venezuela, the impetus for the introduction of fiscal and political decentralization in Colombia came from the national executive, in this case to initiate a peace process with a growing guerrilla movement. Conservative Party president Belisario Bentacur (1982–86) successfully legislated the popular election of mayors, which first took place in 1989, and transferred a larger share of federal revenue to subnational governments during his administration. The transfer of fiscal revenue, however, was accompanied by significant earmarking. The law also gave the president extraordinary authority to issue decrees reassigning to local government specific functions previously carried out by the federal government. National legislators consented to these reforms because Bentacur agreed to leave substantial patronage resources under their direct control.

Of the two sets of reforms implemented by Bentacur, the introduction of direct elections for mayor had the greatest impact. Unlike Venezuela's centralized party organization, candidate selection in Colombia is decentralized in both the Liberal and Conservative Parties. Colombia employs a closed-list electoral system, but each party is allowed to run multiple lists at the department level, and regional bosses within each party determine the rank order of their respective lists. Given such a highly decentralized party organization, the introduction of direct elections for mayors had powerful consequences. Legislators initially opposed to Bentacur's decentralizing measures now depended on mayors to a much greater extent than did their counterparts in Venezuela. Locally elected officials rapidly assumed an important role in drafting regional district lists and ensuring the success of legislative campaigns.

The newfound political weight held by subnational politicians became evident in the constitutional convention of 1991. Responding to popular pressures and a continuing guerrilla insurgency, Liberal president Virgilio Barco (1986–90) used his state-of-siege powers to call a referendum on a national constituent assembly that would enact constitutional reforms. The referendum passed by an overwhelming margin, and elections for the assembly were held in 1990. The seventy members were, however, elected in a single national district instead of from multiple lists within districts. The changed electoral rule gave nontraditional parties (including former members of the guerrilla movement in the M-19 Democratic Alliance) that favored a more decentralized system the opportunity to win the majority of seats in the assembly. Chastened by the referendum's implicit rebuke of the traditional party structure, their minority status in the assembly, and the growing influence of directly elected mayors, candidates from the traditional Liberal and Social Conservative Parties agreed to support a much more extensive form of decentralization under the new constitution.[35]

[35] Mathew Soberg Shugart and Daniel Nielson, "Liberalization through Institutional Reform: Economic Adjustment and Constitutional Changes in Colombia" (Manuscript, University of California, San Diego, 1994); Pedro Medellín Torres, "Reestructuración del estado y desarrollo regional: Contrainsurgencia, democracia y disciplina social," *Revista Interamericana de Planificación* 25 (July 1992); William Dillinger and Steven B. Webb, "Decentralization and Fiscal Management in Colombia," Working Paper no. 2122 (World Bank, May 1999); and Gary Hoskins, "The State and Political Parties in Colombia," in Eduardo Posada-Carbo, ed., *Colombia: The Politics of Reforming the State* (London: Macmillan, 1997).

In addition to introducing direct elections for governors at the provincial level, the new constitution devolved greater financial autonomy upon provinces and municipalities. Both received greater taxing authority, a substantial increase in their share of federal taxes, and the freedom to issue their own debt and borrow abroad. In acknowledgment of their increased autonomy, department and municipal governments were further guaranteed that responsibility for expenditures would not fall to them without the prior allocation of additional resources, a practice that had occurred during the 1980s. Finally, the new constitution eliminated the main source of legislative patronage that the traditional party politicians had used to oil their electoral machines.

Despite these significant moves in the direction of further decentralization, the constituent assembly did reinforce some elements of central control. In addition to retaining a high level of earmarking of intergovernmental transfers, it included a provision allowing the congress to review and possibly revise the revenue-sharing arrangements after a five-year period. Despite public dissatisfaction with the two traditional parties, they continued to dominate the congress throughout the 1990s. This dominance allowed them to use their legislative power to pressure the executive to distribute special investment funds to what remained of their regionally based electoral machines.[36]

In sum, the national executive in both Colombia and Venezuela responded to growing political alienation by proposing initiatives to decentralize. Both introduced direct elections for subnational executive posts. Colombia's party system already granted regional leaders and local bosses tremendous leverage over national legislators. Following the election of mayors and then governors, Colombia underwent a rapid and profound decentralization, as elected subnational politicians gained in influence. In Venezuela, by contrast, a centralized party organization placed greater limits on the ability of subnational politicians to exert influence over national legislators. Until important changes were made in the party system in 1993, legislative careers in Venezuela remained tied to national party leaders to a greater extent than in Colombia.[37]

[36] Shahid Javed Burki, Guillermo Perry, and William Dillinger, *Beyond the Center: Decentralizing the State* (Washington, D.C.: World Bank, 1999).

[37] The recent collapse of the traditional parties and the victory of Hugo Chávez has changed the bargaining relationship between the national and subnational governments. The new constitution passed under Chávez's tutelage appears to recentralize control although vesting it directly in the hands of the president.

Brazil and Argentina

Brazil and Argentina provide a useful comparison because of important similarities in constitutional history, formally federal structure, and the common impetus to revert to decentralized governance following a transition to democracy. Unlike Colombia, which is a unitary state, and Venezuela, which was federal only in name prior to 1989, Brazil and Argentina both have federal constitutional structures dating back to the nineteenth century. In contrast to Colombia and Venezuela, the most recent round of political decentralization was also implemented earlier. Direct elections for mayors and governors were introduced in Brazil and Argentina during the early 1980s and were one component of the transition to democratic rule.

Despite these similarities, decentralization in Argentina did not go significantly beyond the level that had existed prior to centralization under military rule in the 1970s and early 1980s.[38] Moreover, the pace and extent of fiscal decentralization in Argentina has not followed a consistent pattern, as progress toward decentralization has often been accompanied by moves toward recentralization. In Brazil, however, decentralization went far beyond previous levels as state and municipal governments received significant increases over their constitutionally mandated shares of federal revenue. Subnational governments also secured greater debt limits and favorable federal refinancing of existing subnational debt throughout the 1980s and into the 1990s.

Brazil's more extensive transfer of revenue to subnational governments is a product of the close ties that exist between state and local officials and federal legislators.[39] The Organic Law of Political Parties, originally drafted during military rule, mandated that parties hold municipal, state, and national party conventions in which each delegate was chosen by the lower level. Federal legislators were thus nominated in state party conventions, and presidential candidates in the national convention. Because such a structure gave mayors and governors the comparative advantage of distributing patronage in local and state conventions, they were able to wield significant influence over the selection of candidates within their own parties. Federal legislators further reinforced ties to subnational politicians because of Brazil's open-list PR electoral system. With a strong incentive to cultivate a personal vote,

[38] Ernesto Rezk, "Argentina: Fiscal Federalism and Decentralization," in Richard M. Bird and François Vaillancourt, eds., *Fiscal Decentralization in Developing Countries* (Cambridge: Cambridge University Press, 1998).

[39] For an analysis of the relationship between local officials and federal legislators and their career trajectories, see David Julian Samuels (fn. 21).

mayors and governors often aided federal legislators in cultivating a following within specific geographic regions. The fact that legislative elections were held concurrently with gubernatorial elections prior to 1994 further reinforced the pull toward subnational preferences.

With such strong ties between federal legislators and subnational politicians, legislators enacted a series of measures that increased subnational financial autonomy, often to the detriment of federal finances. First, legislators buttressed subnational revenue by expanding their taxing prerogatives and by transferring increasing shares of federal taxes to subnational coffers with few restrictions over their use. Such transfers culminated in the new Constitution of 1988, drafted by sitting federal legislators elected in 1986. While transferring significant revenue to subnational governments, the new constitution was ambiguous about the new distribution of functional assignments. This ambiguity left the federal government responsible for providing many of the same services as before but with fewer resources to do so. Second, federal legislators continually extended subnational debt limits and refinanced the existing stock of state and municipal debt through bailouts at low and fixed interest rates.

The decentralization of revenues without an increase in administrative responsibilities left the central government responsible for activities nominally in subnational hands. The resulting fiscal pressures and mounting and unsustainable subnational indebtedness resulted in crises that prompted attempts to reverse the decentralizing trend. The current administration of Fernando Henrique Cardoso has attempted to curtail recurrent state and municipal fiscal deficits through subnational borrowing restrictions and conditioning federal bailouts on the privatization of state-level government-owned enterprises (GOEs). Although the privatization of GOEs and state commercial banks will permanently restrict state borrowing practices, the current set of borrowing restrictions and debt payment schedules agreed upon by federal and state governments may prove difficult to uphold.[40]

The more erratic pattern evident in the process of fiscal decentralization in Argentina reflects the mixed incentives provided by the party and the electoral systems. Prior to 1997 senators were elected by provincial assemblies, although national parties exercised considerable influence over the nomination process. National parties also exercised

[40] For an analysis of the Cardoso administration's efforts in relation to subnational governments, see Lourdes Sola, Christopher da C.B. Garman, and Moises Marques, "Central Banking, Democratic Governance and Political Authority: The Case of Brazil in a Comparative Perspective," *Revista de Economia Política* 18, no. 2 (1998).

considerable influence over the nomination of candidates for the chamber of deputies, who in turn felt the strong pull of national issues when assembly elections coincided with presidential elections (as they did in 1983, 1989, and 1995). In addition, decentralization in Argentina demonstrates how the partisan makeup of the executive and legislative branches can affect subnational finances.

During the first democratic administration of Raúl Alfonsín (1983–89) the president's Radical Party held a majority in the lower house, while the opposition Peronists (PJ) held a majority in the senate, as well as controlling most of the provincial governments. In view of the constitutional provision that all revenue-sharing bills must originate in the senate, the Peronists prevented the federal government from introducing a new revenue-sharing law between federal and provincial governments. In the absence of federal revenue sharing, the Treasury distributed discretionary grants in order to compensate for provincial budget shortfalls. Provincial governments therefore had the incentive to blackmail the federal government by running up larger budget deficits in order to receive a greater share of federal funds.[41] Such blackmail was successful because a Peronist majority in the senate could threaten passage of any legislation favored by the Alfonsín administration. A new revenue-sharing law was passed only in 1987, after the Peronists assumed the majority of seats in the lower house. The new law increased the provincial share of federal revenue, but at the same time the government tightened the monitoring of provincial accounts by the central bank.

The legacy of the administration of Carlos Menem (1990–99) also demonstrates the mixed character of fiscal decentralization in Argentina. Menem rose within his own Peronist Party on a "federalist" coalition and once in office provided financial relief to provincial governments in 1991. Moreover, he and the Peronist-dominated constituent assembly (made up of congressmen elected with Menem in 1989) enhanced the fiscal autonomy of provincial governments in two ways. For the first time in Argentine history, revenue-sharing arrangements were given constitutional status and protection. The constitution also mandated that "no future transfer of services would be possible unless accepted by the concerned province and accompanied by a matching transfer of funds or revenue sources."[42]

[41] For an analysis of the incentives to provincial governments to increase expenditures in the absence of a revenue-sharing law, see P. Sanguinetti, "Intergovernmental Transfers and Public Sector Expenditures: A Game Theoretic Approach," *Estudios de Economía* 21, no. 2 (1994).

[42] Rezk (fn. 38), 232.

Such favorable agreements, however, were enacted in exchange for centralizing initiatives that included setting provincial spending limits, earmarking how transferred funds were to be used, and transferring responsibility for higher education to the provinces without the promise of additional funding. The Menem government also used party discipline to impose hard budget constraints on the provinces.[43] The federal government in Argentina, unlike that in Brazil, proved successful in forcing provincial governments to undergo serious fiscal adjustments in return for debt relief and the restructuring of banks.

The policy of transferring revenue to provincial governments on the condition that such transfers not compromise federal fiscal goals stands in stark contrast to the pattern in Brazil. This difference derives from the fact that legislative incentives in Argentina are more "national." Governors and regional party leaders exert influence over the composition of candidate lists for the federal legislature, but national party leaders in both the Peronist and the Radical Parties exert some degree of veto power over the makeup of the lists generated by provincial party commissions. Furthermore, Argentina's closed-list PR electoral rules reduce the incentives for legislators to cultivate a personal vote and thus create greater opportunities for legislators to pursue a career independent of provincial interests. While clearly representing provincial interests to some extent, legislators in Argentina, unlike those in Brazil, cannot be characterized as de facto "delegates" of subnational interests.

Mexico

Mexico fits none of the patterns just reviewed. Until the presidential elections of 2000, which brought an opposition candidate to office, its democratic character remained in doubt. Nonetheless, it provides a useful limiting case on the effects of party organization of the decentralization process.

Despite a formally federal structure and history of regional political organization,[44] Mexican politics has been one of the most centralized in Latin America. Until recently the ruling Partido Revolucionario Institucional (PRI) has dominated elected offices at all levels of government and has afforded the sitting president unparalleled control over the nominations of all PRI candidates. As a result, Mexico's political system has yielded a pattern of decentralization much closer to the executive-dominant pattern, although several political reforms and the recent

[43] Burki, Perry, and Dillinger (fn. 36), 42–43.

[44] Lorenzo Meyer, "Un tema añejo siempre actual," in Blanca Torres, ed., *Descentralización y democracia en México* (Mexico City: Colegio de México, 1986), 23–32.

success of opposition parties in federal and subnational elections has begun to change the decentralization process in ways we would predict.

The executive dominated Mexico's decentralization during the 1980s and 1990s. With substantial influence over members of his party,[45] presidents initiated most decentralization measures and crafted them to buttress executive political clout.[46] State and municipal governments receive federal funds through two primary mechanisms: revenue-sharing laws that specify a fixed quota of federal taxes to be distributed to subnational governments[47] and discretionary federal investment programs executed in conjunction with state and municipal authorities. There is substantial debate over the extent to which Mexico's revenue-sharing laws, or *participaciones*, have been manipulated for political ends, but the control of discretionary investment programs clearly has been turned to political ends.

Under the administration of Miguel de la Madrid (1982–88) several federal development programs executed in conjunction with subnational governments were consolidated into one regular budget line called the Desarrollo Regional or Ramo XXVI. Funds designated for state and municipal governments through this mechanism have been substantial and until recently have outpaced funds originating from *participaciones*. The program under this category that has received the most attention because of it sheer size has been the antipoverty program instituted by the administration of Carlos Salinas de Gortari (1988–94) under the title Programa Nacional de Solidaridad.[48] The president determined the program's overall budget, negotiated individual contracts with states, and in some cases created bureaucratic organizations parallel to state and municipal governments that circumvented the power of existing governors and mayors. The program not only garnered support for the president in low-income communities but also reduced Salinas's dependence upon the traditional party hierarchy.

[45] One source of influence by Mexican presidents has been a no-reelection rule for sitting legislators and elected officials at the subnational level. This makes them dependent upon the president for bureaucratic posts or positions within the party. See Peter H. Smith, *Labyrinths of Power: Political Recruitment in Twentieth Century Mexico* (Princeton: Princeton University Press, 1979).

[46] Such a pattern has led one scholar of Mexico's decentralization reforms to characterize the Mexican case as "centralization through decentralization." Victoria E. Rodriguez, *Decentralization in Mexico: From Reforma Municipal to Solidaridad to Nuevo Federalismo* (Boulder, Colo.: Westview Press, 1997).

[47] We are referring to funds established under the Ley de Coordinación Fiscal, which mandates the federal government to allocate revenue to states through three separate funds: the Fondo General de Participaciones (FGB), the Fondo Financeiro Complementario (FDB), and the Fondo de Fomento Municipal (FFM). The FGB, the largest, is more commonly known as *participaciones*.

[48] Cornelius, Craig, and Fox (fn. 14).

TABLE 6
MEXICO
DISTRIBUTION OF DISPOSABLE REVENUE AFTER TRANSFERS ACROSS LEVELS OF GOVERNMENT

Year	*Federal*	*Federal District*	*State*	*Municipal*
1989	73.54	5.05	16.86	4.55
1990	73.82	5.93	15.19	5.06
1991	72.38	5.86	16.07	5.69
1992	70.95	5.85	17.45	5.75
1993	67.41	5.95	20.56	6.08
1994	64.18	5.66	24.12	6.04
1995	64.12	4.86	25.79	5.23

SOURCE: Alberto Diaz Cayeros and Gustavo Merino, "The Measurement of Mexican Federalism: Some Preliminary Data" (Manuscript, 1998).

Since the 1970s the PRI has gradually introduced many political and electoral reforms that have permitted opposition parties to compete more effectively against the PRI. These reforms have contributed to notable electoral successes in municipal, state, and federal legislative races in the 1990s. Opposition parties, which have strongly favored greater autonomy for subnational governments, have won nearly one-third of the country's gubernatorial offices and many municipal presidencies, and they won control of the lower house of the national congress in 1997.[49]

As a result, there was a serious erosion of presidential power and a weakening of party discipline within the PRI during the Zedillo presidency (1994–2000).[50] Presidential discretion over the allocation of investment programs ultimately derived from authority delegated by *priista* legislators who owed their allegiance to the president. When the PRI lost its majority in Mexico's lower house, the federal executive could no longer count upon easy passage of its budget proposals, and federal legislators became increasingly dependent upon opposition governors and mayors. With such a significant change in party politics, the discretionary powers of the president came under attack, and, as we would predict, there were further efforts to increase the share of *participaciones* in relation to discretionary investment programs. As Table 6 shows, the

[49] Burki, Perry, and Dillinger (fn. 36), 46.

[50] Wayne A. Cornelius, Todd A. Eisenstadt, and Jane Hindley, *Subnational Politics and Democratization in Mexico* (La Jolla: Center for U.S.-Mexican Studies, University of California San Diego, 1994).

growing influence of opposition parties in the 1990s has been accompanied by an extraordinarily rapid devolution of resources within the Mexican political system. This trend continued with congress voting for even more transfers in 1997 and 1998.[51]

Party organization under the PRI has been highly centralized under the office of the president. As a result, decentralizing reforms retained a high degree of executive control and discretion and in some cases involved the creation of parallel executive agencies with "branch offices" at the local level. With opposition victories in the legislature and subnational governments and internal party reforms within the PRI, however, the powers of the president weakened. As Mexico's party system moves even further away from a hierarchical mode of organization under the new Fox administration, we would expect decentralization to reflect the interests of subnational governments more closely. Such a process has already begun.

V

There is beginning to emerge a new positive theory of fiscal federalism that focuses on the political relationships among politicians at different levels of government. These relationships are complex and range from the relatively institutionalized, for example, within the context of line ministries, to electoral interdependencies, such as coattail effects and the concurrence or nonconcurrence of elections, to unmediated political, economic, and even military interactions. We have traced one thread of this complex web, arguing that lines of accountability in political parties play a role in structuring the incentives of executives, legislators, and governors with respect to intergovernmental fiscal relations. Even when holding federalism constant, we showed how more centralized party systems were associated with more centralized fiscal structures. Our case studies also demonstrated that the argument could be extended to explain patterns of change. Centralized parties produced more gradual and limited decentralization processes, while increases in the political significance of subnational politicians within parties generated increased pressures on legislators to decentralize. We have limited ourselves to a theory of fiscal federalism, but the argument might be extended to unitary systems and the process of political as well as fiscal decentralization, in short, to federalism itself. Executives in unitary systems vary in their dependence on subnational political and

[51] Burki, Perry, and Dillinger (fn. 36), 46.

social elites; federalism may be precisely a means of striking bargains with such elites in the process of state and nation building.

However these reflections on the origins of federalism—as well as a longer historical view of intergovernmental fiscal relations—raise daunting problems of endogeneity. For the purposes of this analysis we have sharply distinguished the internal organization of political parties from the fiscal structure of the state and have suggested that fiscal decentralization is driven by how parties are organized. The cases studies suggest that in the intermediate run such a focus seems justified. But an alternative argument could reverse the causal arrows. Rather than deriving the fiscal structure of the state from the internal organization of political parties, fiscally decentralized states may produce political parties organized along subnational lines.[52] If our suspicions are correct, studies of the origins of federalism will reveal the importance of lines of political accountability and dependence among political actors operating at different levels, even in the absence of national parties or of subnational jurisidictions. Such findings would suggest the broader applicability of the simple model advanced here.

We close with some observations about the policy implications of our work. After an initial flurry of enthusiasm for decentralization, recent work on the subject has been somewhat more cautious about its purported benefits.[53] Some of these reservations center on the simple lack of administrative capacity at the subnational level. However, many of the problems decentralizing experiments have encountered are powerfully conditioned by the political incentive structures we have outlined here. For example, international financial institutions are giving new attention to the way decentralization can threaten the integrity of government finances by loosening the hard budget constraints on state and local governments and generating subnational debt crises.[54] We have also seen how adequate revenues may not match the assignment of policy responsibilities or, conversely, how revenues can be transferred ahead of actual responsibilities. Finally, there are important questions of equity across jurisdictions that are not raised here but that might be explained by extensions of our theory. We have limited our discussion

[52] See Samuels (fn. 21).

[53] Jennie Litvack, Junaid Ahmad, and Richard Bird, *Rethinking Decentralization in Developing Countries*, Sector Studies Series (Washington, D.C.: World Bank, 1998); Remy Prud'homme, "The Dangers of Decentralization," *World Bank Research Observer* 10, no. 2 (1995).

[54] William Dillinger, Guillermo Perry, and Steven B. Webb, "Macroeconomic Management in Decentralized Democracies: The Quest for Hard Budget Constraints in Latin America," in Shahid Javed Burki and Guillermo E. Perry, eds., *Annual World Bank Conference on Development in Latin America and the Caribbean, 1999: Decentralization and Accountability in the Public Sector* (Washington, D.C.: World Bank, 2000).

to what might be called the "vertical" dimension of federalism: the relationship between the center and subnational governments viewed as a collective. More refined analysis of the allocation of resources *across* subnational jurisdictions is revealing how presidents and legislators seek to use intergovernmental transfers for targeted political ends.[55] This literature is confirming that "horizontal" variation in resource allocation across subnational units is often influenced by the types of political interactions and lines of accountability between center, state, and municipality that we we have highlighted here. The most important point to underscore is that the pitfalls of fiscal decentralization are not simply a result of poor mechanism design—as the new literature on fiscal federalism suggests—but rather reside at a deeper level in the strategic bargaining between levels of government, bargaining that is rooted in features of the political system. Policy prescriptions that yield optimal results in one political system may therefore have very different outcomes in another.

[55] Carol Graham and Cheikh Kane, "Opportunistic Government or Sustaining Reform? Electoral Trends and Public Expenditure Patterns in Peru, 1990–1995," *Latin American Research Review* 33, no. 1 (1998); Edward L. Gibson, "Federalism and Electoral Coalitions: Making Market Reform Politically Viable in Argentina" (Manuscript, Northwestern University, Evanston, Ill., 1997).