TOOLS OF GOVERNANCE: THE IMPORTANCE OF INTERGOVERNMENTAL RELATIONS

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Abstract

What are intergovernmental relations, and why do they matter? The existing literature on decentralization and federalism has provided insights into formal intergovernmental institutions but has neglected the study of informal and ongoing central-subnational interaction. This focus has obscured important questions about how intergovernmental relations operate, including how institutions manifest in practice, the relationships among intergovernmental institutions, and the role that intergovernmental relations play in actually governing. This dissertation argues that an understanding of intergovernmental relations that considers the political and relational processes by which central and subnational leaders interact, along with their formal institutional structure, illuminates the extent to which intergovernmental relations offer an important array of tools that central governments use to expand and exercise their capacity for governance.

To do that, this dissertation explores three questions of intergovernmental relations—when states choose to decentralize, how states distribute intergovernmental transfers, and what drives subnational debt—from an approach that considers informal and relational perspectives along with the formal structures of intergovernmental institutions. I find that central governments use intergovernmental relations broadly and flexibly to pursue their governance goals.

Index Words: Intergovernmental relations, Decentralization, Intergovernmental transfers, Subnational debt, Governance strategies
DEDICATION

To my parents, for always believing that I could do anything at all, and for always
telling me so.

And to Paul, for reading every word; for sharpening the ideas and text; and most
of all for supporting and encouraging me personally as well as professionally.
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1.1 INTERGOVERNMENTAL RELATIONS AS TOOLS FOR GOVERNING

What are intergovernmental relations, and why do they matter?

Originally used specifically to describe public administration issues between the U.S. federal government and the states [33], the term “intergovernmental relations” in political science currently functions as a catch-all covering research that deals with federalism, decentralization, and often even state and local government.\(^1\) Inherent in the term is some sense that these concepts are all related, but interaction across these subfields remains limited in practice. The purpose of intergovernmental relations largely seems to be getting scholars of the varieties of subnational governance and subnational-center interaction in the same room, or the same subsection of professional organizations. Yet there has been little intellectual work to engage them on the same conceptual space. Effective and important work on both federalism and decentralization has explored specific institutional arrangements of multilevel governance, how and why shifts in these institutions might occur, and the implications of such arrangements and institutions. But the broader theme of intergovernmental relations, including how central and subnational leaders interact on an ongoing basis.

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\(^1\)The term retains its relevance to administrative coordination across levels of government in the public administration literature, but this is rarely incorporated into or referred to by political science work on federalism and intergovernmental relations, and is rarely what is meant by the term outside of public administration.
and how the specific institutions governing subnational-center relations affect each other, has been largely neglected.

Specifically, the study of federalism and decentralization has relied too heavily on the analysis of formal institutions, independent of their broader context and ongoing operation. Scholars often implicitly assume that intergovernmental relations can simply be read from the specific federal or unitary structure or institutional level of decentralization, and that shifts in intergovernmental relations occur only in the context of institutional changes. This focus on the formal context governing center-subnational relations, found both in the conceptual conflation of intergovernmental relations with intergovernmental institutions and the common methodological focus on a moment of decentralization, obscures the everyday, shifting, relational character of intergovernmental relations.²

This rift between the reality of intergovernmental relations and the focus of scholars who observe it is unfortunate. The study of intergovernmental relations has important implications for the study of politics, because a deep understanding of the processes and patterns by which central and subnational governments interact has enormous potential for increasing our understanding of institutional forms and their effects; of the relationships among federalism, decentralization, and regime type; and of how the interplay between politics and institutions may affect both local governance and central politics. However, to reap these benefits the study of intergovernmental relations must move away from a focus on intergovernmental institutions to a study of the relations between governments themselves.

I argue here that the term intergovernmental relations can be used fruitfully to describe the political and relational processes by which central and subnational leaders

²This aspect, ironically, was well-understood by the originators of the term, with their focus on the administrative challenges and processes governing federal-state relations, but has since dropped out of most political science understandings.
mutually negotiate political conflict and governance problems, constrained but not defined by the surrounding institutional structure.\(^3\) This understanding illuminates how leaders use intergovernmental institutional structures to pursue their needs and strategies in often unexpected ways, and helps open space in federalism and decentralization studies for a real engagement with the politics of intergovernmental relations. Focusing on a dynamic, adaptive understanding of intergovernmental relations rather than a strictly institutional one also allows us to bring the study of intergovernmental relations into a larger discussion of the tools and strategies that leaders use in their efforts to govern. I argue that intergovernmental relations offer an important array of tools that central governments use to expand and exercise their capacity for governance. A stronger conceptualization of intergovernmental relations will pay dividends across several fields of comparative politics, including federalism and decentralization, state capacity, and comparative political economy.

This dissertation attempts to move in that direction by exploring three questions of intergovernmental relations from a perspective that considers not just the formal purpose of intergovernmental institutions but the deliberate and flexible ways in which governments use these institutions and relations to pursue their governance goals. Doing so requires a stronger accounting of how, in practice, intergovernmental institutions may have unexpected or counterintuitive effects and how overlapping sets of institutions may be used in either complementary or countervailing ways. This approach emphasizes a context in which institutions structure ongoing relations rather than simply constraining action. To begin with, this chapter presents an overview of the current literature on decentralization and federalism, and its weaknesses. It then explores what it means to study intergovernmental relations as a set of political

\(^3\)McConaughey, Musgrave and Nexon [103] suggest that such an approach may also better allow scholars to better engage these concepts with international relations approaches, as IR is the other subfield that deals with "intergovernmental" relations.
and relational processes, and what this approach would add to the study of central-subnational institutions. Last, I introduce the empirical chapters of this dissertation as examples of employing a more developed understanding of intergovernmental relations to interrogate how central governments use intergovernmental relations in the process of governing.

1.1.1 Static Institutions: Current Understandings of Intergovernmental Relations

While the term intergovernmental relations could be deployed to describe any political science work on interactions between central authorities and subnational units within states, in practice this most often refers to two separate strands of the literature about central-subnational interactions: federalism and decentralization. Federalism (a particular institutional form in which some set of subnational powers are explicitly constitutionally protected) and decentralization (a more general description of the extent to which resources and decision-making authority are entrusted to subnational units) are clearly analytically separate and may manifest or affect each other in a variety of ways (see Rodden [128] on the variety of definitions of federalism and decentralization). However, outside of occasional attempts to establish the conceptual boundaries of these different institutions, work on intergovernmental relations generally collapses into approaches that explore how a certain decentralization level or unitary or federal institutional form was reached, or what impact such forms have on subnational politics or policy. Work on these questions rarely explores how these factors interact. The result is a field full of ad hoc observations without a firm theoretical grounding to explain the regularities it identifies. For example, although there is some evidence that federal states are, on average, more decentralized than unitary
states [152], the origins of this relationship are unclear and states with different institutional forms have political processes that manifest themselves in strikingly similar ways. For example, Nigeria, a formally federal state, and Turkey, a unitary state (since 1982), have both seen central leaders use emergency powers to directly take control over restive regions [4, 70]; over the same period, both Canada, which is federal, and China, a formally unitary state, have displayed unusually high levels of subnational spending as a percentage of total government spending (over 1995-2007 this figure averaged 59.68% for Canada and 56.58% for China; the average for all countries in the dataset over this time was 22.49% [83]). The absence of theory to grapple with this pattern is all the more surprising since there have long been arguments that, as Riker noted, formal institutional forms are not necessarily the most important determinants of how local politics or intergovernmental relations work: “the essence of local autonomy has little to do with whether or not the central constitution grants particular rights to local officials” [125, p.139]. In other words, while it may seem reasonable to infer the extent of subnational autonomy or subnational authority from the formal institutional framework, the actual functioning of these relationships may demonstrate the falsity of such assumptions.

Adding to the lack of clarity is the fact that many studies are ambiguous as to whether they address the effects of federalism or of decentralization, a conceptual confusion that does nothing to illuminate the effects of specific institutional forms. Weingast and his coauthors’ otherwise excellent work on market-preserving federalism in China is a prime example of this, where decentralization reforms that may seem to be institutionally binding are informally “upgraded” to federalism [84, 109, 121, 159]. Worse than the conceptual divorce or muddying confusion between federalism and decentralization studies, however, is the fact that the institutional focus of both liter-
atures has led scholars to pay little attention to the dynamic and adaptive strategies that leaders employ in reaction to the institutions they face.

**Federalism as Institutionalized Stasis**

The study of federalism is often especially wedded to explaining the origins of federalism as a specific institutional form, generally enshrined in a state’s constitution, that creates a system of territorially-based vertically divided authority [15, 16, 124, 165].

Relatedly, many scholars also study the effects that federalism has on states that contain these multiple overlapping levels of territorially-based authority. Surprisingly, though, both studies of the origins of federalism and those on its effects, with their shared institutional focus, have led to the study of static arrangements rather than dynamics of change, or even attention to the regular decisions necessary to constantly create and reproduce an equilibrium. Work that attempts to illuminate the origin of federations almost universally focuses on explaining the unification of independent polities into federations, an effort which translates to an explanation of the origins of mutually binding institutional forms; for theorists of federalism derived from the unification of independent polities, institutionally-created stasis is essentially the point [122, 124, 175]. But identifying a local equilibrium fails to account for change.

Additionally, continuing work on the dynamics of federalism recognizes the possibility of change within the federal system, but tends to approach this possibility with normatively-based trepidation. These studies assume that the existing balance of power between central and subnational authorities is desirable but fragile. Much of

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4More restrictive, and less common, definitions of federalism hold that in addition to territorially-based vertically divided authority, other institutional characteristics may be necessary for federation, including democracy [142], unit-based representation in legislatures, or the election of subnational executives [46]. Regardless, scholars using both standard and more restrictive definitions tend to take broadly similar approaches to studying the origins or effects of federalism.
the work on the outcomes of federation revolves around mechanism design and equilibrium studies, exploring how institutions can be organized to maintain this existing balance of power [15, 55, 124], without significant exploration of the empirical implications of either the existing balance of power or the tensions inherent in that balance for governance and policy at both the central and subnational levels. Federalism scholarship that is more empirically-focused also continues to direct significant attention toward the limits that federal institutions exert on central authorities, with relatively little exploration of the efficacy or practical operation of these limits. Some of this preoccupation with limits may reflect the normative agenda of many federalism scholars. A significant literature on federalism explores its potential for managing cleavage and conflict, particularly in ethnically diverse states. Some scholars go so far as to suggest that federalism is the only institutional structure with the “peace preserving” properties required to effectively rule territorially-concentrated ethnic minorities [142]. The intuition behind this line of scholarship is that the limits that federalism places on the central government’s exercise of power in minority regions will appease ethnic minorities’ preferences for autonomy and self-rule, thus defusing ethnic tension and unrest [9, 12, 18, 73]. The evidence, almost entirely cross-sectional comparisons or collections of case studies, is mixed on this front, and no wonder; this discussion of how federal institutions affect ethnic conflict has little room, empirically or theoretically, for whether institutional limits are successful in curbing central interference, how political leaders have adapted or are likely to adapt to the various institutional structures, or what the working relationship between central and subnational leaders looks like.

Both the mechanism design and the ethnic cleavages approaches to studying federalism assume a fundamentally antagonistic relationship between central and subnational leaders. In this account, the purpose of federal institutions is to mutually
bind each level of government from amassing too much power. This division of power is assumed to drive the hypothesized normative and efficiency advantages of federal systems. In this framing, government power exists in a fixed, zero-sum amount and is simply distributed between central and subnational units by the institutions. Practically, this excludes consideration of the ways in which levels of government may interact to either thwart each other or to use their shared resources to pursue goals and to exercise or create government power. All of this suggests that scholars of federalism are neglecting fundamental aspects of how federalism operates in practice. Ultimately, as Riker [125] pointed out in his seminal book review, “Six Books in Search of a Subject or Does Federalism Exist and Does It Matter?,” federal institutional structures are often a bad indicator of the ultimate behavior and outcome of a state. Perhaps institutional limits are less important than the ways in which central and subnational leaders work within them, and federalism is a relatively blunt tool for understanding the fundamentally political and distributional relationship between levels of government.

**Decentralization and Institutional Change**

To an extent, the more recent wave of decentralization literature was a corrective to the static, institutional focus of federalism scholarship. After all, constitutions change only rarely, while responsibility for government revenue collection and expenditures, as well as policy development and execution, shift more regularly. By the 1990s, it seemed clear that the world was becoming increasingly decentralized; in the late 1990s, sub-national government activity on average made up a larger proportion of both total government revenues and government expenditures than they had in 1980 [52], and the period from 1965 to 1995 saw a trend toward increasing local and regional influence in education, infrastructure and policing policies [128]. Much of this was
driven by a policy focus on decentralization, particularly in the realm of international
development. Over the past three decades, the World Bank has devoted resources to
nearly six hundred decentralization projects [171] and USAID has included decentral-
ization as one of five strategic goals in its democracy and governance program [154].
Despite infrequent constitutional changes (and, thus, shifts from unitary to federal
systems), the balance of responsibilities and resources between central and subna-
tional was shifting and, mutually fueled by and fueling this shift, scholarly interest in
decentralization also increased.

The foundational work on the effects of decentralization predates the proliferation
of decentralization reforms, and indeed provided an important theoretical starting
point for decentralization as a development strategy. Early scholars of decentraliza-
tion (who also tended to ignore the niceties of the institutional differences between
federalism and decentralized governance arrangements) often disagreed about the
mechanism through which decentralization could bring benefits, but broadly pro-
moted decentralization as a way of boosting governance efficiency. Through inter-
jurisdictional competition [146], the accommodation of heterogeneous policy prefer-
ences [112], or more efficient gathering and sharing of information [71], decentral-
ization is supposed to provide, on average, preferable policy outcomes at a lower
cost. While the evidence on this front is mixed (see Treisman 153 and Hooghe and
Marks 77) the conclusion that decentralization provides policy more efficiently is
broadly accepted. In all cases, however, these theories are predicated on the idea
that decentralization effectively and clearly redistributes power by restricting central
governments and investing subnational governments with additional authority. As
decentralization invariably involves ongoing interactions and negotiations as policy
is decided and executed, this assumption is questionable. In addition, even if this
assumption is correct, the conclusion that decentralization improves policy efficiency
fails to take the fundamentally political aspects of decentralization into account, and so provides little illumination as to why central governments might prefer efficient policy production over their own relative power. Decentralization is not simply a matter of handing policymaking and execution over to a different level of state official. Instead, it creates new power bases, introduces principal-agent problems, limits central control over available resources, and creates new relationships which may be collaborative or antagonistic. Studying such changes as if they were merely technical obscures their fundamental political implications.

More recent approaches to the advantages of decentralization focus on different outcomes, but follow the same theoretical template, and pitfalls, as the foundational work. Explanations of how decentralization may (or may not) curb corruption [56], increase policy effectiveness [131], increase local participation [100] or spur economic growth [84, 109, 121, 159] are all based on the effective restriction of the relative influence of the central government, and the empirical results backing these theories are mixed (see [25, 126, 127, 130] on economic growth, [53] on corruption, and [153] more generally). Falleti’s 2005 study, which finds that the sequencing of different aspects of decentralization affects the extent to which it effectively empowers governors and mayors, is one exception to the assumption that decentralization inevitably increases subnational power [52]. Despite the more nuanced approach, however, Falleti’s work is still wedded to the idea of decentralization as a series of discrete institutional changes resulting in a shift from one set of static center-periphery relations to a different set of static center-periphery relations. This focus on institutional structures and explicit changes to institutions, rather than the processes that occur and strategies that are employed under the existing institutional framework leaves studies of federalism and decentralization ill-equipped to explain the dynamic and diverse outcomes that occur across similar or unchanging institutions.
A few recent approaches have promisingly begun to grapple with the idea that, after decentralization reforms, central governments then have the strategic space to respond and make adjustments that, explicitly or implicitly, affect the balance of centralization. In particular, Dickovick and Eaton [39], in their study of Latin America, identify four sets of strategies that central governments may use in re-asserting the center’s prerogatives after a period of decentralization reforms. This most closely tracks with the approach I am suggesting here, introducing a variety of institutions and strategies that central governments use to influence intergovernmental relations outside of explicit centralization and decentralization strategies. Similarly, though he focuses more on overall trajectories than specific strategies, Erk [49] has suggested a framework for thinking through the actual outcomes of decentralization reforms and how this evolution may vary even in cases with similar initial institutions. In addition, recent work on the tendency for states to follow decentralization efforts with significant proliferation in the number of subnational units suggests another strategy that central governments may employ to dampen the effects of decentralization, indicating that administrative unit proliferation can fragment intergovernmental bargaining power and administrative capacity, contributing to effective recentralization [67].

These efforts are all important contributions to developing an understanding of decentralization and intergovernmental relations, though they also share some weaknesses. While adding significant nuance to explanations of what happens after decentralization, these approaches fail to complicate the idea of decentralization itself; they continue to take moments of institutional change as their starting point and are thus unable to identify longer-term forces in areas where significant institutional change was absent. In addition, while they consider the strategic options available to central leaders after decentralization reforms, they pay relatively scant attention to the strategic interaction between central and subnational forces. More generally,
they continue to view decentralization fundamentally as a means of limiting central action, identifying central strategies as ways of getting around these limitations; while this is a big step forward, reconsidering the initial reasons for decentralization and possible boons to central leaders, in addition to recognizing potential strategic reactions to these reforms, would provide a better conceptual approach to understanding decentralization decisions.

Shifting away from the effects of decentralization to its origins, the literature still tends to rely on structural and institutional factors rather than more dynamic explanations. Demonstrations of the effects of structural factors on decentralization levels have variously suggested that states are likely to be more decentralized if they are geographically larger, wealthier, more democratic, federal, or come from a particular colonial history [117, 152]. While the findings of this work on structural explanations for decentralization contradict each other on details, these cross-sectional studies do suggest that structural factors are associated with particular levels of decentralization. However, these approaches provide no insight into within-state variation in decentralization levels over time, and fail to address the mechanisms by which these structural variables might drive decentralization outcomes.

Institutional explanations for decentralization could in theory account for more temporal variation in decentralization, but much of the work on how institutions affect decentralization outcomes is based on path-dependent explanations that do not easily incorporate dynamic developments over time. Gerring et al. [62], for example, suggest that indirect rule will be more likely in circumstances where stateness or institutional capacity is higher in the constituent elements of a state or confederation. This argument, however, not only has difficulty accounting for temporal variation in indirect rule (or decentralization) but also accounts for the supply but not the demand side of decentralization decisions. Gibler’s [63] argument that external threat
can allow states to introduce centralization provides for more dynamism than other approaches, but says little about how decentralized polities originated in the first place. Similarly, Escobar-Lemmon’s [51] argument that the type of decentralization expected will depend on which branch of government initiates decentralization reforms also fails to address why decentralization would be pursued in the first place, as well as continuing to view decentralization as a discrete institutional change.

Even those studies of decentralization that touch on its political implications fail to effectively exploit this approach because they continue to identify decentralization as a discrete event, rather than addressing the ongoing political context or give-and-take of multi-level governance. Work that best incorporates a dynamic approach to decentralization focuses on partisanship and the potential advantages to political parties of initiating decentralization reforms. O’Neill [116] and Eaton [45] argue that decentralization is a strategy used by parties to secure political advantage, with O’Neill suggesting that parties will pursue decentralization when their support is more secure subnationally than on a national scale, and Eaton arguing more simply that national leaders will decentralize whenever they think that it will disproportionately advance their party’s interests.

Willis, Garman and Haggard [60, 166], on the other hand, argue that party structure affects decentralization, as states with centralized party structures will tend to be more fiscally centralized, while states where party control is decentralized will be more fiscally decentralized. Lastly, Escobar-Lemmon [50] and Mardones [101] explore the tendency of individual legislators to support decentralization, focusing on the importance of such variables as party prospects, party ideology, district traits, and political background of the legislator. Unlike the rest of the literature cited here, explanations for decentralization decisions that hinge on partisan or even personal political goals introduce a clear political calculus that allows for the possibility of ongoing
political relationships and even for change over time. However, because these explanations assume that leaders are driven by a party-based rather than governance-based political calculus, they can only shed light on democratic states with a strongly institutionalized party system, which represent only a fraction of decentralized and decentralizing states. More importantly, however, even these relatively dynamic accounts still see decentralization as a discrete institutional change that governments initiate and complete, rather than a set of ongoing relationships. While the desire to empower relatively secure co-partisans at subnational levels may make sense (and may, indeed, drive some institutional changes), how do these subnational leaders interact with subsequent central leaders, what adaptive strategies do central governments facing antagonistic subnational leaders employ, and what is the reality of decentralization in divided government? In short, even this approach does little to explore how our understanding of decentralization and intergovernmental relations might change if we view them as an ongoing process rather than a discrete event.

**Next steps in federalism and decentralization studies**

These are the sorts of questions I would like to begin to address with the approach described in the following section, in the empirical chapters of this dissertation, and in the larger research program that this dissertation is meant to begin. In contrast to the static and discrete approach taken in the current literature, the wager I make is that our understanding of decentralization and federalism can be significantly enhanced by viewing these interactions as dynamic processes. Institutions structure but do not determine these relations and they may be either antagonistic or collaborative. In this case, the questions become not why a central government introduced some particular institutionally-based decentralization reforms, but why the state entrusts subnational units with this amount of resources and authority; not how these intergovernmental
institutions affect political and policy outcomes, but how interactions between central and subnational leaders do so, and how these interactions are guided by the institutional structure. Moving beyond institutions and stasis to study how actors use those institutions and conduct the actual practice of intergovernmental relations is an important next step.

1.1.2 Governance as an Active Process

While existing efforts to study intergovernmental relations have provided insight into the origin and effects of specific institutional arrangements, they have also problematized central authority as inherently bad while sidestepping important questions about the processes that sustain or transform intergovernmental relations—as well as explanations about why actors sometimes choose one strategy over another. In contrast, I offer a view of intergovernmental relations as a dynamic, processual realm, in which the state power is taken to be morally neutral and relationships between central and subnational units are ongoing and dynamic.

More specifically, I argue that intergovernmental relations, broadly conceived, are not just “rules of the game,” but are used as a tool by central governments in their efforts to govern. Institutions not only make clear what actors may not do, but also indicate what they can do. Bringing intergovernmental relations into broader perspectives on governance and policy-making suggests that surveying the realm of intergovernmental relations can reveal potential allies for central leaders, suggest additional sites for central action and indicate new strategies for pursuing central goals, in addition to revealing the limits they may place on central action. Taking seriously accounts of regime goals and understandings of governance as an active process, rather than a passive set of institutions, helps to make sense of this account of the opportunities inherent in intergovernmental relations. If governance is an active effort by leaders to
achieve goals, then the levers of intergovernmental relations can provide another set of strategies in this effort.

Generally speaking, states hope to accomplish something in their governance of people and territories; sometimes these goals are benevolent—security for citizens (internally or externally), effective representation of interests and preferences, or socially beneficial policies or services, perhaps—while at other times these goals are meant to pursue personal or group gain, from rent extraction to the amassing of personal or group power. While each of these goals requires leaders or parties to maintain power, a common assumption of the preferences and desires of political leaders (see Wintrobe [168] or Bueno de Mesquita et al. [23] regarding authoritarian regimes and Mayhew [102] or Milyo [106] regarding democratic regimes), that is merely the most basic prerequisite for pursuing these goals. Actually achieving any of these aims, from basic rent extraction to implementing complex social programs in pursuit of desirable policy outcomes, requires significantly more than just being in positions of theoretical power; it requires the availability and effective use of a variety of levers of power. Governance, then, requires the effective application of tools for governance not just occupying the roles of governance.

I situate my view of intergovernmental relations within a deeper view of what “governance" means. In comparative politics, with its overwhelming attention to the identification, creation and maintenance of institutions, it is now relatively rare to explicitly construe governance as an active process imposed on lands and peoples rather than a simple outgrowth of institutions and resources. Explorations of civil society in the context of governance [79, 120] touch on the idea that governance relies on contextual relationships with and among citizens, but rarely connect this context to a mechanism for state action and governance. Even work on failed states tends to focus on a lack of state capacity—meaning institutions and resources—
without consideration of the strategies and tools used for governing. However, while institutions may create or structure tools for governance, it is the strategies that states employ to make use of those institutions, not the institutions themselves, that “create” governance. James C. Scott, a critic of the conventional perspective, has noted that the state’s fundamental project has long been to ensure that its residents are “auditable contributors to the gross national product” and to channel their production so that it is “legible, taxable, assessable, and confiscatable” [135, pp.4-5]. States actively seek to assess, catalog, engage, and compel their subjects, whether for better or for worse, for social or for personal gain. The effectiveness of these efforts varies based on the state’s abilities—in some cases, active governance has been limited to effectively assessing and collecting on tribute from subjects of tribute-taking empires, while some modern states individually catalog citizens’ residence, driving histories, employment and income information, and even healthcare histories. But, while technological advances and entrenched institutions have almost certainly extended the state’s reach, what they have done is to make the process of actively engaging, cataloging and compelling subjects easier. What technology and institutions have not done is transformed governance into a passive process.

My contention, then, is that states are engaged in an active process of governance with the intention of making and executing some type or set of policies, with a rel-

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5Some studies, primarily on Africa [54, 74] recognize the difficulties and limitations states may face in projecting power over certain configurations of geography or people. Even these studies, though, focus primarily on instances of failures of effective governance and expend less consideration on the strategies that are employed for governance and when they are (or are not) successful.

6Scholarship on empire, generally housed in the subfield of international relations rather than comparative politics, does provide more attention to this matter, and will be addressed below.
atively even applicability and effectiveness of this policy across citizens and space.\textsuperscript{7} This process requires some set of strategies or tools for writing and agreeing on policy; tools, intermediaries, and institutions for executing policy; and strategies, tools, and institutions for mobilizing the resources that allow them to execute policies. Political science already has a good sense of many of the tools that states use to accomplish governance. The American government literature in particular has contributed to a broad understanding of how, and how effectively, bureaucracy is used to allow the government to implement and execute policy on the ground;\textsuperscript{8} work across comparative and American politics has provided some insight into how parties and elections, committees and legislatures, personal relationships, institutions for gathering information and other formal and informal mechanisms structure the process of creating policy in the first place;\textsuperscript{9} studies of taxation, tax compliance, government debt and expenditures, and even foreign aid in both political science and economics have provided insight into not only how states can marshal resources to govern but also the long-term implications and availability of resources.\textsuperscript{10} As these examples make clear, institutions certainly provide resources to leaders in attempting to govern; they provide focal points, create and identify allies, structure negotiations and the aggregation of interests, and specify roles and responsibilities; they also create limits on the strategies and tools that states can use to govern. However, while institutions provide resources and tools to governments, the institutions are not themselves tools or strategies for governance. The ways institutions do (or don’t) effectively structure interactions, the relationships they create, the ways in which those relationship are

\textsuperscript{7}Sometimes the goal will not be completely even applicability of policy, but the goal will almost always be policy application that is informed by the policy goals and not by limits to effective governance.

\textsuperscript{8}See [8, 28, 47, 58, 147]

\textsuperscript{9}See, among many others, [7, 26, 35, 37, 59, 86, 88, 97, 99, 156]

\textsuperscript{10}See, for example [5, 6, 31, 44, 104, 132, 144, 149]
used and reproduced, and the ways that leaders use the structures and opportunities created by institutions in expected and unexpected ways—these, rather than the institutions themselves, are the tools of governance.

Intergovernmental relations provide another of the sets of tools that central governments use to accomplish governance. Intergovernmental relations open additional institutional and administrative venues for action as well as introducing potential allies and agents, both of which can be deployed by central governments in the process of governing. Understanding intergovernmental relations in this way both allows and compels researchers to move beyond the surface-level institutions ordering intergovernmental relations—the federal constitution or the formal decentralization reforms—to examine the practical operation of the relationships and interactions that make up intergovernmental relations. Taking this approach to intergovernmental relations also more effectively integrates the questions of decentralization, federalism and intergovernmental relations into more general questions of how states rule and how governments use and maintain power. Intergovernmental relations is not a separate venue of government and politics, but is instead integral to broader projects of state rule.

1.2 Evidence for Intergovernmental Relations as a Tool

The evidence compiled in the three empirical chapters of this dissertation suggests that central governments do use intergovernmental relations not just in a strict, static institutional sense or simply for partisan political gain but as an additional tool in their efforts at governance. Institutions, including those of intergovernmental relations, are flexible and malleable, and central governments exploit this characteristic to use intergovernmental relations to accomplish their own goals. Three specific ways
in which central governments use intergovernmental relations in their efforts to make, implement, and fund policies are seen in the following chapters.

1.2.1 Balancing Act: Efficiency Advantages and Agency Costs in Decentralization Decisions

The first paper makes the broadest and most general claim about the ways in which central governments use intergovernmental relations to pursue effective governance, exploring how and under what circumstances central governments use decentralization in their efforts at exerting authority over the entirety of their state. The argument is that in states that are too large or otherwise too complicated to administer directly, central governments may actually increase their ability to effectively execute policy (broadly conceived) through decentralization. The extent to which entrusting subnational leaders with resources and powers will increase central authority depends on both the extent of principal-agent problems as well as whether central leaders have sufficient resources available to substitute for subnational governance efforts. When central leaders have limited access to resources for governance, and when complementary relationships or institutions exist that allow central leaders to oversee or even trust subnational leaders, central leaders will find the realm of intergovernmental relations a useful adjunct to their other governance efforts. In these cases, decentralization will best be understood not as a simple transfer of power from central to subnational leaders, but instead as an expansion of central power. This shift occurs through the mobilization of subnational allies as well as the complementary deployment of additional institutions to vet, monitor and direct subnational leaders.

This dynamic is demonstrated through two case studies: one, of China, explores the ways in which decentralization may effectively increase control and what strategies
central leaders may use to mitigate principal-agent problems. This exploration demonstrates the importance of decentralized arrangements when the costs of governing a polity outstrip resources. It also shows some of the ways in which central leaders can deploy and cultivate additional relationships and institutions to monitor and control subnational actions, using institutions outside of formal center-subnational relations to effectively take advantage of the opportunities the realm of intergovernmental relations provides. The second case study, of Nigeria, demonstrates the reluctance central governments may have to employing decentralization as a strategy for rule when principal-agent problems are severe. In addition to further demonstrating the importance of decentralization as a governance strategy when resources are limited, it also suggests that limits in seemingly unrelated institutions, including political parties or patronage networks, can have significant effects on the availability of intergovernmental relations as a resource for governance.

This analysis diverges from traditional perspectives of decentralization by pushing back against the idea that central transfers of power to subnational leaders necessarily constitute a limit on central powers. It also pushes back on the argument that central-subnational relations are necessarily antagonistic or zero-sum. As demonstrated here, decentralization may ultimately increase central authority, and the extent to which central-subnational relations are collaborative or antagonistic can affect whether central authorities are able to use decentralization as a strategy for governance. In addition, as the China case study in particular makes clear, decentralization is often not a clear, formal institutional change but can encompass a dynamic set of practices that may be tested, walked back, and redeployed depending on the circumstances and perceived benefits to the center. Decentralization simply provides another set of relationships and institutions that central governments may use when, and in ways that, benefit them.
1.2.2 Paying for Policy: How Central Governments Get What They Want, Even When Institutions Say They Can’t

The second paper turns to how the institutions ordering intergovernmental relations may be used in unexpected or unintended ways to allow central governments to effectively implement their preferred policies. Specifically, I argue that central governments, particularly those that are institutionally constrained in their direct control over subnational policies, use intergovernmental transfers as a tool to work around explicit institutional constraints and to expand their policy reach. Central leaders use their control over the distribution of intergovernmental transfers to “pay for policy,” inducing reluctant subnational units to choose policies that are closer to central preferences by providing relatively larger transfers. Using intergovernmental transfers as a policy tool allows central governments to increase their control over policy and create some measure of policy convergence. Interestingly, this finding that subnational units that are more distant from central preferences receive larger intergovernmental transfers is somewhat in tension with the argument of the previous paper in which subnational units that are more distant from central preferences are less likely to be entrusted with decentralized powers. This suggests a somewhat complex relationship in which subnational divergence from central leaders causes central leaders to resist decentralization but, when they do decentralize, more distant or dissimilar subnational leaders receive more benefits.

I demonstrate the logic of the center using intergovernmental transfers to induce policy convergence with a formal model of central and subnational decision-making on central transfers and subnational policy. I then test the implications of this model with analysis of the Canadian case. One of the implications of this argument is that co-partisans of central leaders, who should naturally be more inclined to imple-
ment centrally-preferred policies, should actually receive relatively smaller intergovernmental transfers because they do not need to be compensated for the policy they implement. I test this hypothesis using quantitative time-series analysis of Canadian intergovernmental transfers from 1961-2009 and, indeed, the analysis suggests that having a provincial premier who is a co-partisan of the Canadian prime minister is associated with intergovernmental transfers that are smaller by between 137 CAD and 429 CAD per person. I also explore the Canadian case qualitatively, focusing on the Canadian central government’s use of the federal spending power to encourage policies that follow central preferences. This analysis suggests that intergovernmental transfers can be a powerful tool for central governments in generating uniform policy, even when formal intergovernmental institutional arrangements provide them with little policy leverage over subnational units.

If central governments can use intergovernmental transfers to encourage particular policies, this complicates the more traditional view of intergovernmental institutions as primarily creating constraints for central action, suggesting that the array of intergovernmental institutions can be used flexibly and creatively to pursue central governance even when those same institutions may seem intended to primarily constrain the center. As the Canadian case suggests, interaction between the center and subnational units can vary across time even as institutions are static; while the formal relationship between Ottawa and Montreal or Vancouver remains the same, relations, particularly in the form of intergovernmental transfers, vary with both central and subnational political outcomes. In addition, focusing on how more flexible, centrally-led institutions may interact with formal intergovernmental institutions like federalism provides a better understanding of the everyday operation and effectiveness of intergovernmental institutions and how they interact with intergovernmental relations to produce outcomes.
1.2.3 Decentralization and Increased Debt: Accident or Strategy?

The third paper argues that central governments take advantage of the intergovernmental character of expenditures and budgeting in most modern states to protect their own budget balance and to expand the funds available to spend, sometimes leading to dire consequences. While existing research on intergovernmental fiscal relations suggests that certain institutional structures create incentives for subnational overspending, over the preferences of central leaders, I suggest that in some cases central leaders actually use these institutions to their own advantage; rather than an inevitable effect of institutions that passively constrain central abilities to introduce budget constraints, subnational overspending is sometimes a result of active governance decisions by central leaders. In particular, central governments use the intergovernmental character of government budgeting and spending—which divides expenditures and budgets across subnational units and intergovernmental levels, obscuring overall spending and budget balance—to increase available resources and expenditures without affecting central budgets and debt balances. In this case, subnational overspending would be a way for central governments to essentially hide expenditures, and intergovernmental fiscal relations would be a tool, though a perverse and inadvisable tool, for central governments to fund expenditures, policies and programs. I then test this theory using quantitative cross-national time-series analyses to determine if there is evidence that central governments shift expenditures to subnational budgets, using subnational expenditures to substitute for central expenditures. The evidence suggests that this is, in fact, the case: lower central expenditures on social services, higher levels of expenditure decentralization, and lower levels of revenue decentralization are all associated with higher subnational deficits; and larger subnational deficits are associated with smaller central deficits.
Again, this line of argument cuts against the common understanding of intergovernmental institutions as passive structures constraining central action, repositioning them as additional arenas and opportunities for central leaders to pursue goals. Intergovernmental institutions—in this case the formal separation of central and subnational budgets, and the formal separation of responsibility for those budgets—do not simply lock in a status quo. Nor do they leave the system uniquely open to exploitation by subnational governments, as if they provide arenas for action only for subnational and not for central actors. Instead, central leaders often see opportunity in intergovernmental institutions and use their informal and ongoing relationships with subnational units and leaders to their advantage, including by shifting responsibilities and cajoling subnational leaders into taking over additional spending to the advantage of central leaders’ bottom lines.

Though these three papers consider different types of intergovernmental institutions and relations and make separate arguments about the particular operation of these institutions, they share an approach that places intergovernmental relations and institutions in the context of central attempts to exercise governance across states, using whatever tools and strategies are available to them. Using this approach to examine different facets of intergovernmental relations in different contexts it becomes clear that central governments rarely see the institutions ordering intergovernmental relations as fundamental and passive constraints on central action, but instead see them as a starting point, creating relationships and ordering strategies that become part of the central government’s repertoire of governance. Depending on the institutions and on central needs, these strategies may involve ongoing negotiation over empowering (and monitoring) subnational leaders to perform governance tasks; using, and varying, central spending across subnational units and over time to encourage particular policy outcomes; or using the separation of central and subnational bud-
gets, and their leverage over subnational leaders, to improve central budgets. But in each of these cases, intergovernmental relations provide a tool that central leaders use flexibly and on an ongoing basis to achieve their governance goals in the context of existing institutions. A better understanding of intergovernmental relations will require an accounting of these flexible and ongoing uses of intergovernmental institutions alongside the explanations of the institutions themselves.

1.3 Implications

Taking seriously the idea that intergovernmental relations should be understood as a set of relationships and processes that introduce both opportunities and limits for central action has several implications both for specific questions within the intergovernmental relations literature and for how we understand intergovernmental relations and decentralization more broadly. The existing decentralization and federalism literatures have contributed significantly to our conceptualization and knowledge of the institutions governing central-subnational relations. However, pushing forward our understanding of the everyday operation and practice of intergovernmental relations, decentralization, and federalism will require several shifts in the approach that scholars and researchers take.

For attempts to explain the effects of decentralization, for example, a view of intergovernmental relations that accounts for ongoing processes and relationships would suggest that neither existing nor proposed institutions can be taken at face-value. Studies exploring the estimated or anticipated effects of decentralization, for example, often theorize based solely on the intended or stated function of decentralized institutions without seriously considering the idea that institutions may not function as designed or may have unexpected effects; institutions that appear designed to limit
or reduce central power, then, are studied as if they actually do limit central powers. This has led to limited or mixed empirical support for the theorized effects of decentralization. By contrast, an approach that focused on the practical functioning of decentralization reforms—how intergovernmental institutions are likely to play out in their political and institutional context—would suggest that these institutions are subject to use or exploitation by both central and subnational actors, and that the effects of decentralization cannot be read from decentralization reforms without reference to the strategies and approaches that central and subnational leaders are likely to deploy in response. In short, the intended or explicit purpose and the functional effects of decentralization institutions must both be considered.

Similarly, studies of the purpose and origins of decentralization often evaluate the results of decentralization reforms in relation to their stated purpose or functioning; if central authorities indicate that decentralized institutions are meant to increase subnational authority or policy efficiency, the success of these institutions and the soundness of decision-making about decentralization are evaluated against the extent to which decentralized institutions actually increase subnational authority. Taking the purpose of decentralized institutions at face-value and evaluating the reasoning behind or effectiveness of decentralization based on these stated justifications obscures any central purposes behind decentralization that are less savory or politically agreeable. If central leaders are political as well as bureaucratic actors then the reasoning behind introducing decentralized institutions almost certainly has a political purpose that may be either complementary to or at odds with the stated purpose. While some studies have incorporated this approach, a more consistent focus on determining the underlying rationale behind allowing for decentralized institutions and whether that rationale is congruent with or contrary to the stated explanation would improve our
understanding of both why decentralization occurs and why the effects of decentralization often vary.

If intergovernmental relations involve a series of ongoing processes, scholars of decentralization would also do well to more seriously consider dynamic or intra-institutional changes in intergovernmental relations alongside the institutional modifications that have generally been their focus. The scholarly emphasis on decentralization reforms, thought of as specific points of institutional change, has captured important developments in center-subnational relations, but has neglected shifts that are less abrupt or less formal. If we consider that intergovernmental relations consist of both institutional frameworks and ongoing center-subnational relationships, institutional revisions are only one possible source of change. We would gain a better understanding of how intergovernmental relations change or endure over time with greater attention to ongoing or gradual shifts in the relationship between central and subnational leaders, and to how seemingly tangential institutions may be layered onto the primary intergovernmental institutional framework to alter its effects. The use of federal expenditure and budgeting practice to shift provincial behavior, or shifts in the working relationship between central and subnational leaders that constrain effective subnational authority may be illegible from the perspective of institutional change but nonetheless affect the texture and outcomes of intergovernmental relations.

More broadly, we will gain a better understanding of the purpose and effects of intergovernmental relations if we begin to think of governance as a process rather than an outcome, and to think of intergovernmental relations in particular as a process of governing over space. While geography is clearly not the only dimension over which governance occurs, the demands of governing across territory have long been of acute importance to political leaders. The hardening of political boundaries has reduced its importance in the comparative politics literature, introducing the now common
assumption that, given sufficient resources and institutionalization, the process of governing over space has become automatic or trivial. With exogenously-determined preexisting borders, states are assumed to be administratively organized for governing their given territory and any difficulties in doing so are not indicative of the inherent pressures of governance nor of a failure the execution or availability of strategies, but simply a lack of “state capacity,” the answer to which generally involves additional resources.

While additional resources may be useful in governing over space, the literature on empire provides strong evidence both that extensive resources are no guarantee that central authorities will be able to effectively govern peripheries and that, given effective and effectively-deployed strategies for rule, central authorities may be able to project power even in circumstances of limited resources.\footnote{For a variety of reasons, work on empire generally falls under the international relations subfield; in its broadest terms the argument I am making here is that comparative researchers should pay more attention to the concept of empire and, perhaps, re-appropriate it.} Scholars suggest several sets of strategies that empires’ central authorities use to govern the peripheries: for example, rulers employ strategies that divide and localize conflict, reducing the likelihood of concerted resistance against the center \cite{110}; they collaborate with and co-opt local leaders to extend their reach \cite{96}; they organize administrative structures to most effectively extend central directives while maintaining the key levers of control \cite{34}. The use and effectiveness of these strategies has depended on local circumstances and central needs, but the literature on empire makes clear that central authorities have long drawn on a diverse repertoire of strategies and approaches to establish and extend their reach, conditioned on the resources at their disposal. Though modern states, with their relatively fixed boundaries and established governing structures,
often differ from traditional understandings of empire,\textsuperscript{12} this does not mean that the challenges of governance that empires face have disappeared. Moving back toward considering the needs and strategies of actively governing over space, and paying real attention to the strategies that central authorities within formal states use to project power and govern over the breadth of the state would significantly add not only to our understanding of intergovernmental relations, but to our accounts of the general mechanics of governance and stateness.

Last, reorienting our understanding of intergovernmental relations as a set of strategies and relations (structured by institutions) that central authorities use in the process of governance re-situates intergovernmental relations as just one of a collection of approaches and strategies that states use to govern. Instead of constituting an entirely separate sphere of governance with different rules and reasoning, intergovernmental relations is part of the larger project of governance and used alongside strategies and institutions from bureaucratic administration to political parties, co-option of civil society to patronage networks. Considering intergovernmental relations as an essentially separate arena of political action obscures its role in larger questions of comparative politics and governance.

From canonical insights into federalism and decentralization to contemporary approaches that question and re-examine orthodoxies, scholars have provided a significant foundation of knowledge and theory about the institutions and structures of intergovernmental relations. The bulk of this body of literature, though, has important flaws that obscure some of the fundamental questions in intergovernmental relations: why do central governments entrust subnational leaders, who may or may not be loyal, with authority? how and by what mechanisms do central-subnational relations change

\textsuperscript{12}Though empire-like arrangements within established states are more common than is commonly recognized.
over time, and how is (or isn’t) this related to the institutions of intergovernmental relations? what is the role of intergovernmental relations in governance and state-building? I suggest that reconceptualizing intergovernmental relations as a dynamic, relational realm of interaction between central and subnational authorities, one that provides resources and strategies for governance, will bring us closer to answering these important questions and will better position political science to understand the importance and implications of intergovernmental relations as a whole. While some political scientists have moved toward this conceptualization of intergovernmental relations, the underlying reasons for these approaches have not been systematically presented or clearly theorized.

This dissertation, then, hopes to accomplish two things. First, in this chapter, I present the argument for viewing intergovernmental relations as relational, adaptive, dynamic, and integral to larger governance efforts. Second, in the following chapters, I demonstrate practically how this conceptualization of intergovernmental relations provides new and sometimes surprising insights about how intergovernmental relations affect governance, policy and politics. While this goal is larger than a single dissertation, I also hope that this understanding of intergovernmental relations can provide a foundation for a larger research program focused on the role that intergovernmental relations plays in central governance, and how intergovernmental relations both constrain and enhance the projection of central power.
Chapter 2

Balancing Act: Efficiency Advantages and Agency Costs in Decentralization Decisions

2.1 Introduction

The broadest and most fundamental tool that intergovernmental relations offers to central governments as they work to govern is that of decentralization itself. Research on decentralization has long suggested that it may increase governance efficiency and decrease costs, and when central resource constraints are considered it becomes clear that this increased efficiency can lead to direct increases in governance capacity. Decentralization does create agency costs, however, and managing these costs in an effort to increase central authority—in other words, using decentralization effectively as a tool—requires sustained relations and engagement between central and subnational leaders. The availability of decentralization as a tool for governance leaves why and when states take advantage of this tool as open questions. This chapter explores the opportunity that decentralization can offer as a tool for governance, then develops a theory of how states balance the attendant efficiency gains and agency costs to determine whether decentralization is the appropriate strategy for their circumstances.

2.1.1 Why Decentralization?

The Communist Party of China, which rules a dauntingly large territory, an even larger population, and a variety of ethnic groups, relies on expansive networks of
decentralized governance institutions (from village communes to local party congresses) to exert authority. While some scholars express surprise at China’s decentralized governance because of its authoritarian regime [91] the Chinese have long used decentralized approaches in managing their territory [134, 169]. Nigeria, though smaller, is also vast (particularly with regards to population) and encompasses three major ethnic groups and myriad smaller minority groups. Unlike China, however, Nigeria maintains centralized governance structures (despite being formally federal) and refuses to meaningfully empower subnational units in governance [9]. Because of limited governance capacity, Nigeria has faced significant and continuing threats to its integrity and stability [75], most recently the ongoing insecurity and chaos engendered by Boko Haram [32]. This contrast is puzzling: on the one hand, why, given its authoritarian structures and interest in maintaining control does China entrust governance to subnational units? Or on the other hand, why, given its difficulty in asserting authority across its territory, does Nigeria insist on maintaining centralized governance structures?

Existing explanations provide little clarity on this point. Work that focuses on the efficiency advantages of decentralization or its effectiveness at quelling ethnic and nationalist sentiment [9, 73, 112, 146] seems to suggest that any state, or at least any state dealing with ethnic minorities, ought to be better off by decentralizing power. Work that focuses on the governance imperatives of central leaders, and particularly their need to amass economic and political resources to maintain power [59, 94, 167], however, seems to suggest that decentralization would rarely if ever be a reasonable choice for central leaders. What then explains this variation? Are Nigerian (or perhaps Chinese) leaders simply off the equilibrium path, failing to execute strategies that would benefit them?
I propose instead that we must consider both influences in tandem if we are to understand decentralization decisions. When considering decentralization, leaders take into account both the potential benefits of decentralization and also the potential impact that shifting state power toward subnational leaders will have on central authority. I argue here that decisions regarding decentralization are the product of balancing the governance capacity benefits of decentralization against the principal-agent problems that it introduces. As is often argued, decentralization can increase the efficiency and effectiveness of governance and can manage subnational demands for autonomy. However, it may also introduce significant principal-agent problems that not only limit the effectiveness of central government but may also strengthen potential political opponents and reduce central authority. Central governments must balance these competing considerations in making decentralization decisions. Where strategies and institutions for managing principal-agent problems are readily available, I argue that central governments may actually *increase* their overall authority through decentralization— in contrast to most understandings of decentralization which see central and subnational authority as a zero-sum. However, where strategies for managing principal-agent problems are scarce, central governments will reasonably be reluctant to decentralize even when facing fundamental challenges to state effectiveness and capacity.

This theory does more than simply resolve the empirical puzzle. If decentralization is a matter of balancing principal-agent problems against the potential governance advantages of decentralization this has important implications. First, if this argument is correct then central governments may actually increase their own authority through decentralization. This suggests, contrary to most understandings of decentralization, that central-subnational relations are not necessarily zero-sum and that
decentralization may have important implications for overall governance, for better or for worse.

Furthermore, it suggests that the two types of normative advantages of decentralization—its efficiency advantages and its democratic and representative effects—are in tension. In contexts where central leaders are able to keep firm control on subnational leaders, decentralization is more likely to occur but less likely to have strong democratizing effects. In addition, if decentralization affects not just the distribution but also the creation of state power, then its use can no longer be thought of as fundamentally democratic, but instead must be understood as part of larger strategies of state governance and authority.

This chapter continues with a discussion of the existing literature on decentralization and governance, and specifically how this literature fails to account for the relevant factors in decentralization decisions and, thus, empirical variation in decentralization outcomes. In contrast I develop an argument whereby central leaders make decentralization decisions taking into account both the potential advantages of decentralization and the possible agency costs they will face. To demonstrate this logic I present a formal model of central decision-making regarding decentralization. Finally, I explore this dynamic using case studies of China and Nigeria’s approaches to decentralization over the past several decades.

2.2 Choosing Decentralization: Effectiveness and Authority

The existing literature presents two major explanations for why central governments would pursue strategies of decentralization. The first focuses on the efficiency advantages conferred by decentralization. Explanations of the mechanism vary, but claims that decentralization makes governance less costly and more effective, whether
through promoting inter-jurisdictional competition [146], accounting for heterogeneous preferences across space [112], or increasing the availability and reducing the cost of information [71], have a long history. Relatedly, some scholars argue that the appropriate jurisdictional size for some types of services may simply be smaller than most states’ territory, a possibility that is bolstered by the empirical regularity in the size of units at which various governmental services are provided [77]. The argument that decentralized or indirect governance is more efficient is intuitively appealing (as large organizations are often unwieldy and slow to gather or act on information) and has become an underlying assumption throughout much of political science.

In explaining central approaches to decentralization, however, this argument has several weaknesses. First, as indicated by Treisman [153], even if governance is more efficient when differentiated within the state or executed in sub-state units this does not necessarily point to decentralized governance as a solution. Information can be collected sub-nationally and relayed to central decision-makers, central decision-makers can differentiate policies based on local needs, and the appropriate jurisdiction size for any given policy may vary, making fixed sub-national units poorly adapted for executing every policy [153]. In addition, arguments that assert the fundamental superiority of decentralization for governance efficiency suggest no reason that any state larger than, say, Liechtenstein should fail to decentralize.¹ Nevertheless, there remains significant variation in levels of decentralization even among much larger states.²

¹Hooghe and Marks [77] cite the multi-level nature of governance in even Luxembourg as evidence of the efficiency advantages of decentralization.

²While the several largest states are all fairly decentralized, as measured by subnational expenditures as a percent of total government expenditures, the largest, Russia, is significantly less decentralized (at 38.8% expenditures at a subnational level in 2001) than the second largest, Canada (at 60.1% expenditures at at subnational level). More dramatically, for only the twenty largest countries for which the IMF has fiscal decentralization data, the percentage of government expenditures at a subnational level ranged from 1.16% (Iran in 1974—by 2008 that had grown only to 6.4%) to 63.96% (China in 2006). When considering
The second major approach to explaining why central governments would pursue decentralization focuses on the extent to which decentralization can allow the central government to tie its own hands, and the benefits this hand-tying may bring for economic growth or appeasing ethnic minorities. In terms of the economic advantages of decentralization, the literature on market-preserving federalism suggests that it may be a mechanism by which central governments commit to not interfering in the economy, thus encouraging stronger economic growth [84, 121, 159]. Not only is this hypothesis disputed, however [24, 25], but it again centers on the unmitigated good of decentralization and provides little explanation for why central leaders would ever be reluctant to decentralize.

A broader literature on how limiting central action through decentralization provides benefits argues that decentralized governance arrangements quell ethnic conflict and nationalist sentiment, reducing local demands and pressure for secession [9, 18, 73, 142]. The logic behind this is, as Amoretti and Bermeo [9, p.11] suggest, that decentralization or federalism can combine “the advantages of shared rule with those of self-rule”. Put differently, as Hechter [73] argues, in states with geographically-concentrated ethnic minorities decentralization makes the boundaries of units of governance more congruent with those of nations, thus short-circuiting impulses toward nationalism and secession. Empirical explorations of this argument turn up mixed results. Scholars generally agree that decentralization may quell nationalist demands and reduce ethnic conflict, but some argue that income level, the mix of consensual and majoritarian democratic institutions, cultural factors [9], or the level of resources available to the central government [73] might reduce the effectiveness of this strategy. These concerns about how external factors may reduce the effectiveness of decentralization.

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the most populous rather than geographically largest states the range of decentralization is the same [83].
ization in mitigating ethnic conflict, though, do not clearly address whether or not decentralization may in some cases be actively deleterious in managing ethnic conflict or simply ineffective. Nor do they suggest how central governments would determine whether decentralization would be sufficiently effective in a particular case—or what they should do when it would not be.

In addition, like the above arguments for decentralization, while this logic is compelling it is also absolute. If decentralization increases subnational self-rule and reduces secessionist threats and ethnic conflict (whether or not it is always sufficient to eliminate them) there is no reason that any state with ethnic minority movements should rationally fail to decentralize. As scholars of ethnic conflict are aware, though, this does not fit the empirical record. For example, as Walter [157] notes some central governments have indeed offered some measure of sovereignty to concentrated ethnic minorities, as in Canada or India, while others, including Russia and Iran, steadfastly refuse to compromise and instead faced armed rebellion. While the literature on ethnic conflict provides a variety of explanations for this, from consideration of the value of the stakes and likelihood of prevailing [40, 148] to a more complicated calculation of potential future challengers and long-term losses [157], these considerations have not been incorporated into more general work on decentralization decisions.

Last, both the market-preserving and peace-preserving arguments for decentralization hinge on the idea that the limits that decentralization places on central action are in fact effective at constraining central efforts and interference. If these limits are flexible, or if central leaders employ strategies for working around them, then the advantages of credibly committing to not interfering in the economy or of providing self-rule and independence to contain ethnic conflict are no longer applicable. This matters because there is a burgeoning literature on the approaches that central governments use to reassert authority in the face of decentralization [39, 49, 67]. If central
governments can and do continue to devise ways to interfere in subnational affairs then any commitment that decentralization implies is incredible and the argument that central governments decentralize to reap the benefits of tying their own hands must be reconsidered.

In general, while the logic pointing to decentralization as an advantageous strategy is compelling, it proves too much. If the effects of decentralization are as strong and advantageous as these accounts suggest then states should be clamoring to decentralize. Despite the hype, however, the actual empirical record, while tending toward decentralization, is significantly more complicated and mixed than these theories would suggest. Much of this literature also indicates that the effects of decentralization efforts should be clear reductions in the authority and influence of the central state in subnational areas, a claim that is also much stronger than the mixed empirical record supports.

2.2.1 Decentralization and Governance Concerns

A review of scholarship that focuses not on decentralization but on the governing imperatives of the central state, however, gives some sense of why central leaders may be wary of decentralization. Much of the literature on decision-making by central leadership in both autocracies and democracies focuses on the basic imperative of maintaining power [23, 102, 106, 167]. Leaders or parties stay in power by distributing rents or implementing policies that are preferred by their supporters. These efforts require access to resources and policy-making levers to be able to deliver benefits to those who keep central leaders in power [59, 167], and decentralization limits access to these resources.³ If central leaders are unable to effectively monitor and collect

³Though a less common assumption, this argument also applies if central leaders are assumed to be amassing rents or pursuing policy preferences of their own.
resources from subnational units or influence the direction of subnational policy then
their ability to deliver benefits to their supporters will be impaired, regardless of
how efficient policy may be or how well ethnic conflict is contained. In addition,
decentralization affects the distribution of power into the future. By committing to
tying their own hands by limiting their authority over subnational units, then, central
leaders may be reducing their ability to govern in future periods. While effective
relationships with and monitoring of subnational leaders could allow central leaders
to reap the benefits of decentralization without imperiling their influence or access to
resources, existing understandings of agency costs [43, 158, 161] suggest that access
to this first-best solution will be limited.

From a pure central leadership perspective, then, decentralization is inherently
suspect. It may have benefits, but should require strong inducements to make it
worthwhile for central leaders concerned with maintaining access to the resources
and policy-making that keep them in power. The literature on decentralization sug-
gests what these inducements may be, but in addition to a mixed empirical record
it does not acknowledge why or under what circumstances failing to decentralize
might be a rational decision. What none of these approaches have done is to take
central incentives for and against decentralization into account in tandem. Central
leaders know that decentralization has certain advantages in terms of effectively and
efficiently managing the periphery but also presents dangers in maintaining central
authority.

I argue that understanding how central governments balance these incentives is
imperative for understanding decisions regarding decentralization. When principal-
agent problems are severe then central concerns about losing authority and access
to resources will overwhelm the benefits of decentralization. However, when central
governments can overcome principal-agent problems then it can exploit the advan-
tages of decentralization without reducing their influence or access to resources in
the periphery. In these cases, decentralization, counterintuitively, increases central
authority.

2.3 Central Authority: Balancing Efficiency and Agency Costs

Considered broadly, the existing literature on governance and decentralization sug-
gests both advantages and disadvantages to decentralization, but these have not been
considered together in understanding how central governments balance these tensions
to make an effective decision regarding decentralization. I suggest that central gov-
ernments evaluate these competing influences by explicitly balancing the potential
agency costs of decentralization against its potential reduction of governance costs.
Furthermore, I suggest that they do so under conditions of constrained resources,
another consideration that previous studies of the efficiency advantages of decentral-
ization have not explicitly addressed. To make this argument I begin with a discussion
of the theoretical basis by which central governments make this calculation, followed
by a simple decision-theoretic model to make the logic of this trade-off clear. I then
develop some implications of the theory before shifting into discussion of the cases.

As discussed above, the possible advantages of decentralization have been thor-
oughly considered. Decentralization is widely thought to lead to more efficient, less
costly governance [112, 146], though there remains significant disagreement on the
mechanism behind this. In addition, to the extent that decentralization can help
manage ethic conflict and quell separatism simply through empowering subnational
groups [73], this can also be considered a boon for governance costs; quieting ethnic
unrest through the transfer of governance powers is almost certainly less directly
costly than expending considerable resources on active suppression efforts or buying
off subnational groups with direct rents. While existing approaches emphasize these advantages, they also largely assume that to take advantage of them the center must fundamentally limit its authority within the state. However, incorporating a budget constraint into considerations of decentralization, which other treatments of the efficiency advantages of decentralization have failed to do, provides a mechanism by which the hypothesized efficiency gains of decentralization can have implications for governance more broadly. When considering the efficiency gains of decentralization in the context of constrained resources, decentralization can lead to actual increases in governing capacity in addition to increased efficiency or higher surpluses.

The likely disadvantages of decentralization for central leaders have received significantly less attention in the decentralization literature but can be inferred, in part, from other discussions of governance and delegation. By shifting resources and responsibilities to subnational units through decentralization, the central government limits its own access to resources as well as limiting its ability to observe and direct policy and decision-making, resource collection, and resource distribution. These concerns fairly directly track traditional considerations of principal-agent problems in the economics literature and later in political science [43, 158, 161]. Decentralization will cause outcomes to diverge from central preferences as central leaders reduce their ability to monitor and influence policy. Beyond traditional economics-based understandings of agency costs, decentralization can also empower potential rivals or separatists, increasing the power of political challengers by giving them legitimacy and resources. While I fold this danger into the larger concept of agency costs it is worth noting that under decentralization severe agency costs can have particularly dire implications for central leaders.

In short, if the center wants to govern—whether that simply means effectively extracting resources or involves implementing large and complex social programs—it
must have the ability to monitor, influence and sanction things that go on across the state. The challenge is how best to ensure this authority: by taking advantage of the efficiency of decentralized governance or by eliminating agency costs through central control. Additionally, the center’s governance goals must extend beyond simple governance throughout the state to include the projection of central authority across the state. While subnational units and leaders can provide governance, this is irrelevant or even detrimental to central leaders if they are unable to exert any authority over this governance. Put another way: if the central government expends any resources on public goods, central leaders must find using decentralization to defuse a secessionist threat to be better than not just centralization but also than allowing secession. Traditional explanations for decentralization address the issue of governance, but not that of authority. But if the central government is severely limiting its ability to influence everything in the periphery from resource collection to policy-making to rent distribution, how much should it really matter to them how efficiently the periphery is governed? If, however, a budget constraint is incorporated into our understanding of decentralization and authority, as the model presented below does, it is possible to see how decentralization can increase not only governance efficiency but central authority. And, if agency costs are taken seriously, it is also possible to see when and why central governments would fail to decentralize, even when it could mean more effective governance.

2.3.1 Model

The idea that decentralization can increase central authority is counterintuitive because the underlying logic behind decentralization, even for those who tout its advantages for governing, is the limiting of central prerogatives and decision-making. Because this argument is counterintuitive, a simple model can help make clear the
logic by which central governments may gain authority through decentralization as well as when and why they might reject it.

Suppose a government is faced with a state of size $A$ to govern. This state is made up of $n$ subunits of size $a$ such that $n = \frac{A}{a}$. It is simplest to think of these sizes as representing geographic area, but the logic is no different if it is taken to represent population or even some measure of governance “degree of difficulty.”

Central leaders also face governance costs per sub-unit, defined as $c$ if governance is centralized and $d$ if governance is decentralized. These governance costs represent the minimum that the state must invest to to ensure basic compliance and projection of central authority throughout its component subunits. Without this level of investment in governance, the center will face some measure of ungovernability from subnational units, from policy resistance and tax or revenue non-compliance to outright rebellion. Following the decentralization literature, which suggests that governance is more efficient and lower-cost when decentralized, I assume that $d < c$.

For simplicity’s sake, then, and without loss of generality, I fix $d$ such that $d = 0$ and assume that $c$ is greater than 0 such that $c \in (0, 1]$. I also suggest that the state is resource-constrained and assume that it has a budget of $B$ to spend on governance.

The central government has two options. It can govern in a centralized manner, incurring the higher centralized governance costs. With this decision they purchase governance such that the level of governance under centralization, $g_c$, is:

$$g_c = B - cn$$

In this case, if $B$ is at least as large as $cn$ then the center has full governance or even a governance surplus.\(^4\) If, however, $B < cn$ then the center faces a governance deficit and subnational resistance.

\(^4\)This surplus could then be either extracted as personal rents or reinvested in policy influence or the distribution of rents or public goods.
Alternatively, the central government can decentralize and incur the lower decentralized governance costs. However, though it will face lower governance costs if it decentralizes the central government will also face agency costs, as its control over subnational leaders will be imperfect and contracting over the breadth of issues involved in governance will necessarily be incomplete. I conceptualize these agency costs as conditioning the effectiveness of the center’s governance efforts such that $B$ is effectively reduced. To effect this I introduce a measure of agency costs $\phi$ such that $\phi \in [-1, 1]$. Using this formulation, agency costs are less severe when $\phi$ is larger (because the effective governance budget remains close to the full amount of $B$). Under decentralization, recalling that governance costs under decentralization were normalized at $d = 0$, the center’s level of governance is measured as:

$$g_d = \phi B$$

In this case, when agency costs are minimal ($\phi$ is closer to 1) the center has a governance surplus. When agency costs are high, however (as $\phi$ approaches $-1$) they become severe enough to create a governance deficit. Under decentralization, a governance deficit may appear different than it would under centralization, as officially sanctioned subnational leaders rather than non-government actors are now the center of resistance, but to central leaders the danger is similar: loss of policy or revenue compliance or even outright rebellion.

Even considering agency costs, though, explicitly incorporating both the higher cost of centralized governance and the state’s budget constraint makes clear that decentralization can certainly increase central governance capacity, and potentially even shift the government from a governance deficit to a condition of effective governance. Indeed, if $g_d > g_c$, or:

$$\phi B > B - cn$$
the central government will gain increased governance authority under decentralization. This holds so long as agency costs are sufficiently manageable (so long as \( \phi > 1 - \frac{cn}{B} \)) and so long as central budgets are fairly constrained in relation to governance costs (so long as \( B < \phi B - cn \)). In these cases, if we assume that central governments want to maximize governing authority (whether to forestall resistance or simply to extract higher levels of rents) central leaders will choose decentralized governance.\(^5\)

On the other hand, if central governance budgets are high relative to governance costs and if agency costs are severe, then decentralization can wreck central authority rather than increasing it. If agency costs are severe relative to centralized governance costs (if \( \phi < 1 - \frac{cn}{B} \)) and if central budget constraints are sufficiently high (if \( B > \phi B - cn \)) then decentralization will lead to lower central governance authority as agency costs swamp the lower governance costs of decentralization. Indeed, if central governments are maintaining even a small governance surplus under centralization but face particularly high agency costs (such that \( \phi < 0 \)) decentralization can actually create a new governance deficit; less acutely, in the context of severe agency costs decentralization could also reduce governance surpluses and deepen governance deficits.

### 2.3.2 Implications

This model and its underlying theoretical framework suggest several implications for how central decisions regarding decentralization should be understood, when central

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\(^5\)In some cases decentralization will flip central governments from a governance deficit (if the cost of centralized governance, \( g_c \), outstrips the governance budget but \( \phi \) is positive) while in some cases it may simply maximize a governance surplus or minimize a governance deficit.
governments are likely to turn to decentralization, and when agency costs will prevent them from utilizing the benefits of decentralization.

First, when states have significant resources in relation to governance needs (when \( B \) is high) the importance of decentralization for ensuring governance and increasing authority wanes. As the model indicates, under conditions of high budget constraints central governments are less likely to gain from decentralization. This makes practical sense as well. For states that have sufficient governance capacity the ability to rely on subnational leaders for governance is largely beside the point. Empowering subnational leaders may generate a larger governance surplus, but it will not change the terms of governance. Thus, when central budget constraints are high decentralization should be less likely.

For states that lack significant state capacity in relation to governance needs (where \( B \) is low), however, the potential advantages of decentralization are more consequential.\(^6\) In these cases, the reduced governance costs of decentralization can make a real difference in terms of governance, sometimes shifting states from a governance deficit to a governance surplus. If agency costs are manageable (if \( \phi \) is close to 1) the central government will increase not only governance but also central authority through decentralization. Thus, where central budgets are constrained but agency costs are manageable decentralization should be more likely and should result in relatively more effective governance.

If, however, state capacity is low (\( B \) is small) \textit{and} agency costs are severe (\( \phi \) is close to \(-1\)) central governments may be unable to take advantage of the lower governance costs of decentralization because it will reduce central authority, despite improving

\(^6\)Note that the important factor is not absolute budget constraints but budget constraints in relation to governance needs. In states with high governance costs, whether due to sheer size or terrain or to ethnic or linguistic diversity, budget constraints may be severe even if governance expenditures are significant in absolute terms.
governance. In fact, if agency costs are particularly severe decentralization can even deepen or create a governance deficit. Thus, full consideration of agency costs can explain why central governments would be reluctant to decentralize even when it may seem as if decentralization could provide more effective governance. In cases where central budgets are constrained but agency costs are severe, then, decentralization should be unlikely and effective governance should likewise be unlikely.

A final implication of this approach to decentralization strategies is that while each of these factors (central budget constraint \( B \), agency costs \( \phi \), and the relative cost of centralized governance \( c \)) is affected by institutions, none of them is actually institutional in nature. They may shift over time for reasons exogenous to decentralization decisions or institutions. From the center’s perspective, being able to respond to these influences dynamically is better than being bound by inflexible institutions. This suggests that, in practice, decentralization strategies should be dynamic and responsive across time.

2.4 Empirical Strategy

I explore the implications of this theory empirically through analysis of both the Chinese and the Nigerian central governments’ approaches to decentralization decisions. These cases were chosen to focus on the particularly interesting set of circumstances where the central budget is constrained in relation to governance needs so considerations of decentralization and agency costs have significant implications for governance capacities. The process of balancing between exploiting the governance advantages of decentralization and relying on potentially undependable agents leaves states with more severe budget constraints with two options: either they have enough faith in their subnational leaders to entrust them with powers and increase central governing
authority; or they find that trusting subnational leaders is too risky and instead find their ability to govern across their territory hampered, often severely.

The comparison between China and Nigeria provides significant insight into these two options. While this analysis does not cover the behavior of central governments in states with high resources in relation to governance needs, these two cases do provide evidence for the other implications of the theory presented here. First, the analysis of China provides process evidence for the argument that, when agency costs are manageable, decentralization can actually increase central authority. The China case also provides examples of how central governments manage agency costs, as well as evidence for the dynamic approach that central governments take to manage decentralization and agency costs over time. In comparison, the Nigeria case provides evidence that even when budget constraints are tight (relative to governance needs) more severe agency costs make central governments less likely to choose decentralization. In addition, the analysis of Nigeria provides some insight into the governance implications of situations where budget constraints and governance costs would indicate decentralized governance but high agency costs make that strategy unpalatable to the central government.

2.4.1 China: Decentralization and Increased Authority

Given its huge size, enormous population and significant ethnic diversity (including concentrated ethnic minorities) China’s budget constraint would be limited in relation to its governance needs almost regardless of its absolute budget. To deal with this constraint, the People’s Republic of China (PRC) has long utilized decentralization strategies to maintain significant governance powers, relying on its ability to cultivate and induce loyalty from subnational leaders.
Significant attention has been given to China’s fiscal decentralization and marketization of the 1980s and 1990s, but the PRC’s history of relying on decentralized arrangements to extend central power extends much farther back. Mao did succeed in consolidating power partly through centralization, which reached a high point around 1954 when most major central ministries had extensive, vertically integrated networks across China [134, p.190]. However, Mao quickly realized the limits of centralization, particularly the massive amounts of information required to achieve central objectives in diverse circumstances. By 1957 significant decentralization was underway. Much of the Third Plenum of the Central Committee was devoted to discussion of decentralization [134, p.195], and soon afterward the powers of central state ministries were curtailed and provincial Party committees and regional branches of government took over these powers [134, p.153]. Later in the PRC’s development, by 1984, the Central Committee further limited its direct control over governance by changing personnel policies; it limited the leadership under its direct control from a two-rank down system (ministerial and provincial level leaders and their direct reports) to a one-rank down system (just ministerial and provincial level leaders) [173, p.228]. This reduced the number of leaders under direct supervision of the Central Committee from about 13,000 to just 5,000 [69, p.79].

Control over economic even issues also shifted downward under Mao, and then again under Deng’s reforms. By 1957, subnational governments were gaining more autonomy over their budgets in the name of self-reliance. While heavy industry remained under the purview of the central government, responsibility over both light industry and agriculture was almost entirely shifted downward [134, p.205]. The slogans of the day, used to explain and inform about the new policies, were: “Get the Best out of Each Area”; “Self-reliance”; and “Downward Transfer of Authority” [134, p.206]. Even responsibility for allocating supplies and fixing prices was handed over to provin-
cial authorities [134, p.208]. Under Deng this economic decentralization expanded. Not only was revenue collection almost entirely the responsibility of local government, but local governments became responsible for the local economy, state-owned enterprises, land use and natural resources as well as provision of public services [76, p.2]. In addition, after 1983 local governments gained more real autonomy in expenditures. Supervision of budgets shifted from yearly negotiation over transfers, with fiscal plans issued by the center, to renegotiation of revenue shares only every four years (increasing stability) and looser oversight of general expenditure levels and priorities [123, p.145]; [174, p.132]. The principle at work in local governance was “do the best according to local conditions,” meaning that central leaders lay out general principles and goals, but the provinces develop specific policies for their achievement [174, p.12]. Even in security, at the height of the 1989 movement against the government provincial governments acted independently to control the student movements in their territories, working toward central goals but with independent authority [174, p.2].

In recent years, the central government has also given more powers and autonomy to elected subnational bodies in China, including local congresses and provincial legislatures. Starting in the 1990s, local congresses were given additional authority in overseeing the work of local government, with expanded powers in raising proposals, suggestions, and criticism and in compelling local government responses [98, p.36]. Local congress representatives are particularly expected to identify and represent local concerns and interests as they coordinate with both local governments and party committees to make policy [98, p.37]. Provincial legislatures have taken on even stronger governing responsibilities [30]. They now take an active part in personnel selection and coordinating with the local party to supervise local government institutions [30, p.3]. This decentralization was fundamentally driven by central government decisions
to devolve authority, rather than by pressure from below [30, p.6]. Instead of con-
stantly seeking approval from the CCP for any significant lawmaking, Shanghai in
particular has been allowed to shift to a situation in which the legislature simply
submits regular legislative plans, while their day-to-day work continues unimpeded
[30, p.20]. In addition, this work actually matters. Since the 1990s local laws have
begun to carry more weight relative to administrative regulations [30, p.25].

The purpose of these decentralization strategies was not to empower local elites,
or even to maximize efficiency, but instead they were intended to use the available
efficiency gains to more fully and effectively govern the Chinese state. As an old
Chinese saying describes, from the province’s point of view, “the sky is high and the
emperor is far away” [174, p.xii]. The center’s challenge, then, is to find a way to bring
the power of the emperor—or, nowadays, the general secretary—to the periphery,
despite his remoteness. Decentralization has in many ways served this purpose.

Chinese leaders who advocated decentralization in 1957, drew on earlier imperial
and republican Chinese experience, and understood the power of decentralization for
transmitting the center’s authority to the periphery. A 1957 text on government in
China, for example, notes that “[i]n regard to all questions having a regional aspect,
if the opinions of the people’s committees in that are not respected, if the regional
peculiarities of that area are not considered, then deviations will develop in the execu-
tion of tasks” [134, p.191]. In other words, central priorities cannot be faithfully exe-
cuted without some allowances for regional differences, as determined by subnational
leaders. This understanding is also inherent in the principle of “do the best according
to local conditions,” which recognizes that provinces have advantages in determining
and adapting to local needs to accomplish central goals [174, p.12]. Furthermore, the
central government was less able to gather accurate and timely information, particu-
larly as the economy grew and became more complex. Through the mid 1950s the
center was making significant decisions on the basis of “inadequate or erroneous information,” while subnational leaders with access to the relevant information had no authority to act on it [69, p.25]. These impediments to subnational governance and development, however, were readily mitigated with decentralization.

Later, in the 1980s, the shift from a two-rank to a one-rank system of supervision similarly reduced the workload of the central government in a way that allowed for more active and effective governance [173]. The two-rank down system, with 13,000 positions to monitor, often led to pro forma approval of whoever was nominated for the position, while the more decentralized one-rank system allowed for more active and engaged governance [173, p.228]. Similarly the fiscal decentralization pursued at this time was intended primarily to allow subnational units to effectively bring in tax revenue, and particularly to expand tax receipts, when central institutions had limited capacity to generate the information and create the monitoring systems necessary to do so [69, p.94]. When the central government later realized that this system was leading to leakage in tax revenue, there was some recentralization of revenues, though decentralized expenditures continued to be extremely high (70% in 2004 [91]).

The basic limits of the center’s resources and abilities also explains recent shifts toward increased autonomy for subnational elected bodies. As Manion [98] argues, the increased autonomy of local congresses in representing local interests, making policy, and overseeing local government is structured to motivate ordinary citizens to convey relevant information and congresses to transmit that information. Local congress autonomy is fundamentally a strategy for tapping local knowledge for central advantage, in a way that centralized governance could never achieve [98, p.2]. For provincial legislatures, as they address increasingly complex policy problems the center’s ability to directly control this process shrinks dramatically. In the decade from 1980 to 1989, for example, the local legislature in Shanghai promulgated only
50 laws, which the central party individually reviewed and approved; in the following
decade this number tripled and the party’s ability to directly control lawmaking
disappeared, while the need for these laws continued or grew [30, p.22]. In partic-
ular, the expanded powers extended to local legislatures have allowed them to serve
the function of gathering information about the local public, understanding local
social problems, listening to local public demands, and generally gaining a better
understanding of the concerns and demands of the Chinese populace [30, p.95]. This
increased information has not only been used in lawmaking, but has also been passed
on to central authorities to increase their knowledge of potential issues or concerns
[30, p.95]. This function can only be accomplished at a local level, and having a
local institution that can serve this purpose not only provides more responsive and
tailored governance but also gives central leaders more extensive information about
the population’s mood, concerns, and preferences than they could gain if legislating
and policymaking were more centralized. Not only that, but placing lawmaking at
a local level has allowed for conflicts of interest to be worked out through compro-
mise and deliberation coordinated by local legislatures, allowing for laws that pursue
central priorities but minimize the number of losers from the legislative process and
generate greater satisfaction with government [30, p.42]. This cannot be achieved with
a centralized or even a centrally-controlled lawmaking process.

In short, the Chinese state has, over decades, used real transfers of authority to
subnational leaders as a means of expanding its ability to govern effectively. This has
allowed the center to effectively project authority across the state, despite its size,
complexity and diversity of circumstances and needs. This approach to governance has

\footnote{These strategies of exploiting subnational elected bodies to improve the authoritarian state’s access to relevant information parallels arguments that authoritarian governments use democratic institutions at a central level to improve access to relevant information and strengthen authoritarian rule [59, 97].}
been possible because of the variety of methods by which the central state has been able to induce fidelity in subnational leaders. As [91] argues, “the carefully controlled process of economic and administrative decentralization actually has strengthened the regime and reduced the incentives within the Chinese leadership to depart from the political status quo” (p.27).

Many of the control structures tasked with ensuring the loyalty of subnational leaders are vested in the party system. Subnational leaders, with real authority in their governing roles, have been mirrored at every level by Party units and Party members, with direct Party hierarchy and discipline [134, p.139]. In addition to direct supervision and control, loyalty within the Party system has also been ensured through personnel policies. Party secretaries, for example, were required to have served for at least three years in the Party (and for at least five years for larger cities or industrial centers), to weed out those with questionable loyalty before putting them in positions of power [134, pp.152-3]. Furthermore, local leaders were often brought in from elsewhere, ensuring that loyalty to the province did not run too deep [69, p.30]. When loyalty was questionable subnational leaders were simply removed, both as punishment and as warning. Following decentralization under Mao, there were several purges of local personnel, and most were for charges of localism [174, p.92]; local leaders could pursue local programs, but their aims and loyalty must belong to the center. The state’s control over many aspects of an individual’s life, from employment to housing and food, helped ensure that pleasing central authorities with loyalty was a compelling imperative [69, p.2].

The Chinese state’s continuing approach to personnel control maintains central influence over subnational leaders through systems of selective punishment and reward. Direct sanctioning regimes, particularly regarding local instability and mass incidents, have been institutionalized since the 1990s; if mass incidents occur under
a local political leader that leader faces “demotion or dismissal regardless of their performance in other domains" [95, p.712]. In this particular area, the central government has signaled a clear priority and provided strong incentives for local politicians to follow suit [95]. More subtly, mechanisms of corruption control strengthen their ability to control agency costs, as the mandate system of rule that subnational leaders must adhere to makes the identification of corruption selective rather than absolute [21]. Because the mandates or expectations of subnational leaders are hierarchically ranked, failure to adhere to a mandate may constitute corruption or it may be driven by a legitimate concern that adherence would conflict with the implementation of a higher-ranked mandate [21, p.57]. This makes corruption more difficult to identify in the Chinese case, but it also gives the central government greater latitude in identifying and punishing corruption, increasing incentives for subnational leaders to follow central wishes. Furthermore, seemingly technical changes have increased the CCP’s ability to induce agent fidelity through personnel policies. For example the central decision to strictly enforce the cadre retirement age since approximately 1990 has had the effect of not just reducing the average age of mayors but has also ensured a larger number of open promotions through which to reward secondary officials [92]. More broadly, center-led shifts in cadre policies and norms, from promotion standards to retirement expectations, have allowed the CCP to “reduce the exorbitantly high costs of monitoring local officials...without compromising its hold on power" [91, p.27].

In addition, the state has used money as a means of ensuring that subnational leaders’ loyalties lie with central rather than subnational interests. Grants, for example, are often given to subnational units with the understanding that successful completion of project goals can lead to additional grants and that subnational leaders may keep any remaining funds at the completion of the project [76, pp.27-28]. Subnational leaders thus have both personal and professional incentives for faith-
fully carrying out central priorities. While other direct forms of control, including recruiting local leaders from outside, have lessened over the decades [69, p.30], reliance on monetary incentives has increased [76, p.28] in an increasingly marketized China.

The recent empowerment of Chinese local legislatures has also not happened without the introduction of control mechanisms, particularly in the local legislature’s relationship to the party. Legislatures work hard to make connections with and gain support from the Party, which is what allows them to accomplish work, both directly and in relation to local government [30, p.63]. Legislatures also perform their own control function, monitoring and reporting on the functioning of local governments, particularly the extent to which they faithfully execute both local laws and central policies. This function, however, is only executed with the support and approval of the local party, with its clear vertical ties [30, p.59].

China’s control systems have not always been entirely effective at controlling regionalism, and there has been back-and-forth on some of these issues, including the intrusiveness of Party monitoring and the autonomy of revenue collection. However, most serious opposition to the reigning central government has traditionally come from other factions at central levels—indeed, some of the impetus in empowering subnational units has been in service of curbing the influence of large central ministries. While localism and lack of fidelity from subnational units is galling, it has rarely been existentially dangerous to the central leadership in the PRC. As a result, Chinese leadership has had the luxury of progressively fine-tuning the mix of decentralization and central control mechanisms as well as the specific mechanisms used for control. This has allowed Chinese leadership to take advantage of decentralization and improve both the effectiveness and the sheer scope of governance in the periphery in a way that, as the next section will show, is closed to Nigerian leaders.
In contrast to China, Nigeria represents a case where its governance budget is low in relation to its governance needs, but severe agency costs mean that decentralization would be even more detrimental to central authority. Nigeria, though geographically smaller than China, is nevertheless large. It is among the ten largest states by population, and encompasses three major ethnic groups and myriad ethnic minorities. Its governance investments, however, are nowhere near adequate to these needs: health outcomes, including control of diseases like polio and the safety of routine medical procedures like childbirth are poor [75, p.24]; government spending on education has fallen steadily over the past two decades, despite explosive population growth [75, p.24]; and even basic territorial control is compromised by insurgent groups like Boko Haram and the Movement for the Emancipation of the Niger Delta [75, p.24].

Nigeria has extremely limited state capacity in relation to both development needs and the variety and severity of threats to central authority. However, it is in a situation where decentralization to existing subnational leaders is so risky as to be unworkable. Instead, the center maintains a strong hold on the apparatus of the state, but this approach results in large swaths of the country being essentially ungovernable.

Despite its nominally federal character and the relative authority of subnational governments in the pre-independence era [143, p.27], Nigeria is a fundamentally centralized state [9]. This tendency was entrenched during Nigeria’s periods of military rule and in response to the secessionist movements it has faced, but it has continued in Nigeria’s fourth republic [115]. While the Nigerian constitution technically reserves certain policy areas for subnational governments, other outlets for central power, including control over transfers and tax revenues as well as expansive emergency powers, almost entirely mitigate this effect [22, 114]. The exercise of these central-
izing powers is not hypothetical. Subnational access to tax revenues is extremely limited, and in 2004, for instance, the federal government withheld funds from Lagos and four other states after they deviated from plans passed by the National Assembly [115, p.35]. The federal government’s emergency powers have also been used a number of times. In 2004, then-president Obasanjo declared a six-month state of emergency in Plateau State, suspending local government structures, in response to violent outbursts, but perhaps also related to his poor relationship with the governor of Plateau State [115, p.95]; in 2006, it was Ekiti State facing a six-month state of emergency, in an apparent power play against a governor that had been facing centrally-led impeachment proceedings [115, p.94]. More recent states of emergency have been called in the states of Borno, Yobe, Plateau and Adamawa in 2011 and 2013 by then-president Goodluck Jonathan [13, 22]. While these states of emergency were less obviously politically motivated, they continue to show the limits of formal subnational powers in the face of central decision-making. Central anti-corruption efforts have also had consistent centralizing effects. Central leaders have pursued impeachment proceedings against governors and encouraged selective targeting by the Economic and Financial Crimes Commission, as a blunt means of controlling subnational governments and leaders [2, 114].

In terms of direct policy intervention, the federal government regularly interferes with local government affairs and policy areas, including basic education, public housing, agriculture, and rural development; in addition a number of federal institutions and commissions exert a centralizing influence through their national reach in areas from justice to primary education and the minimum wage to anti-corruption efforts [9, p.341]. The significant increase in the number of states in Nigeria has increased these centralizing tendencies, fragmenting institutional resistance [115,
Perhaps most significantly, however, Nigerian states have no constitutional ability to establish independent state police units [9, p.340]. Law enforcement in Nigeria, then, is entirely centralized, which limits or eliminates the possibility of subnational contributions to state security and order, despite facing significant security challenges. Overall, the central government exerts significant direct control over Nigerian states in terms of fiscal policy, policy development and implementation, and security. It refuses to rely on, and often even hinders, state governments’ potential ability to govern within their territory.

Given the deficits in political order and public good provision in Nigeria, why do they not decentralize and give subnational governments the opportunity to collect revenue, impose order and provide public goods in their smaller and more manageable boundaries? Nigerian states may have the ability to impose order within their territories. While central reach is limited, smaller breakaway areas within Nigeria (from Biafra to Boko Haram’s areas in the north\(^9\)) have at times maintained internal order even in the face of ongoing conflict, though they have never effectively provided widespread public goods. Instead of empowering state governments, however, Abuja seems intent on maintaining a tenuous but absolute grasp on the entirety of the state. I suggest that this stems from a justified lack of trust in the fidelity of Nigeria’s subnational agents to central desires. While decentralization might indeed provide governance advantages, the expected lack of agent fidelity overwhelms these potential advantages and makes decentralization an unattractive choice for central leaders. From a central perspective, decentralization would risk empowering a large

\(^8\)See Grossman and Lewis [67] for a more general treatment of how subnational unit proliferation strengthens central authority.

number of subnational elites with few connections to central leaders and with signif-
icant geographic and ethnic bases of power.

Regional and ethnic differences have long served as the basis for power and patronage in Nigeria, leading to a fragmented and competitive political system and making it difficult to find areas of agreement and mutual advantage. Upon independence, the central Nigerian state faced three strong ethnically-based regions, which were already internally self-governing, and which posed a significant threat to the central government; indeed, through the 1950s and 1960s, each of these regions threatened secession [9, p.331]. The central government made it a priority to fragment and disperse subnational power, but the basis of that power has been harder to change. Before independence, the British relied extensively on indirect rule, strengthening the authority of traditional political institutions in the north and inventing strong tribal institutions where they did not then exist [143, p.22]. Upon independence, to secure northern support, the north’s feudal authority system was explicitly left intact, supporting the continued development of a fragmented and patronage-based political system [87, p.34]. This has resulted in a system where one’s ascent to power is mediated almost exclusively by the regional (ethnicized) party machinery, and so loyalty to this fragmented and narrow slice of the Nigerian political establishment, rather than any central political elite, is required for advancement [87, p.166]. The explicit political patronage system in Nigeria, commonly known as godfatherism [82], itself operates at a state level, with wealthy patrons buying state positions for their favored politicians. This further severs any patronage or loyalty ties state-level politicians may have to the center [82, p.111-126]. Political loyalties and party affiliation are overwhelmingly geographic and ethnic, making cross-cutting, broad-based party appeals nearly impossible [3, p.72]. As a result, no true national-level political elite exists, and the ties between subnational and central leaders are tenuous at best.
Furthermore, when regional leaders have been allowed to pursue their own policies, this has backfired for the central government because of existing ethnic and religious disagreements; in 1999, when some northern states unilaterally extended existing arrangements for Sharia law to criminal matters as well as civil cases, protest and violence erupted, heightening existing tensions [3, p.47]. Even more problematically, in areas where local concerns (generally of an ethnic or religious character) are not perceived to have been addressed, ad-hoc methods for enforcing local order have sprung up: ethnic militias have emerged which sometimes kill those suspected of action against local ethnic interests; illegal state police forces have been created in states governed by the sharia criminal code and have dispensed harsh and illegal sentences; and governors have been known to create kill squads to eliminate potential local political opponents ([9, p.341]; [3, p.138]). When facing this sort of defiance under the current centralized arrangements, it is unsurprising that central leaders would fear that subnational insubordination would prove harder to control if partially legitimized by decentralization.

In addition, current political realities, undergirded by the historical development of the Nigerian state, have reinforced the idea that control of the central state is primarily an opportunity for complete control over the resources of the state, to the advantage of a leader’s home region or ethnicity. The benefits of governance are perceived to be concentrated at the center, and the electoral process is simply an opportunity to install an ally that can deliver benefits to your group [3, p.28]; once in office, it is difficult to walk back these localized promises, and instead of distributing resources to create a durable state-wide network or constituency, leaders perpetuate the fragmented and competitive nature of the current system. Oil revenues have exacerbated this trend, both increasing the flow of revenues to the center and increasing inequality across states, making leadership of the centralized power
structure only more attractive [10, p.261]. As noted by Horowitz, Nigeria typifies a case where ethnic tensions are centered on the national level of politics [78, p.239-240], which has made the potential empowerment of subnational elites a risky prospect. Ultimately, the centrifugal tendencies caused by ethnic and regional tensions, emphasized by the secessionist movements the Nigerian state has periodically faced, have, rightly or wrongly, caused the central government to see centralization—of resources, power and policy—as the best defense against ethnic nationalism [75, p.68]. While decentralization may provide an opportunity to increase the capacity for and quality of governance at a local level throughout the state, without either informal or institutional loyalty from subnational leaders to the center this prospect is simply too high of a risk for central leaders to pursue.

As a result, however, the ability of the Nigerian government to exercise control over the state has been severely hampered. Basic public goods are in short supply, physical security cannot be guaranteed, and central control over subnational political leaders and policies cannot be assumed. The Nigerian state is too large and complex, and has too little capacity and too few resources, for the central government to effectively govern. However, the risks of subnational infidelity, from extended challenges at the central level to state fragmentation and breakdown, foreclose perhaps the best chance the Nigerian government has to exert control throughout the state.

2.4.3 Discussion

While the theory and model presented suggest the calculus central leaders use to consider both the efficiency advantages of decentralized governance and the potential agency costs of empowering subnational leaders, the case studies above suggest the consequences of this calculation. In states that have sufficient central governance capacity, the ability to rely on subnational leaders is largely beside the point. For
states that lack sufficient state capacity, often particularly large or complex states, the calculation is more consequential. As seen in Nigeria, if subnational leaders are not to be trusted—if significant deviation, fragmentation, or even challenge would result from empowering them—then the center insists on keeping its power despite the fact that this will inevitably result in poor or incomplete governance. Where subnational leaders are faithful (and where small deviations are unlikely to be disastrous) as in China, the possibilities for effective and coordinated governance expand tremendously. Central balancing between governance efficiency and subnational agency costs has real effects not only on decentralization but also on the basic effectiveness and reach of governance.

2.5 Conclusion

The evidence presented here suggests that central governments may decentralize because doing so expands the center’s ability to govern and increases overall central control over the state. Through most of the literature, decentralization is understood to be about sharing or distributing resources and authority, rather than expanding and creating state power and resources. Based on the theoretical model presented here, however, this understanding is incomplete if we accept two simple assumptions: 1) central governments face resource constraints in the governance efforts and; 2) decentralization of governance creates some efficiency advantages. If we accept those assumptions, under some circumstances decentralization will expand the central government’s authority over the state. The history of decentralized governance in China supports this understanding of decentralization, as the Chinese state has deftly employed decentralization strategies to more effectively rule its periphery. This would suggest that extricating the study of decentralization from its firm connection
to democratization and placing it in the larger repertoire of state approaches to power and rule would be fruitful in understanding both decentralization and state power.

While recognizing the opportunities that decentralization introduces for expanding central authority and influence, however, acknowledging the issue of agency costs in decentralization provides an explanation for why states might forgo those advantages. Where agency costs are severe, decentralization would limit central authority, despite increasing the efficiency of governance, so central governments will resist decentralization. Nigeria’s maintenance of a fundamentally centralized state despite its governance difficulties, a product of the severe agency costs it faces, provides support for this way of thinking.

I argue that central leaders are well aware of both the governance advantages and possible fragmentation of state power that decentralization may entail, and that they choose decentralization strategies based on their desire to maximize governing ability while minimizing agency costs. This would mean that in states where decentralization would have the greatest effect on the diversification and democratization of power, because subnational leaders would have more latitude to deviate from central preferences, decentralization is unlikely to occur.

Similarly, in areas where we do see decentralization, a full understanding of the effects of this policy on democracy and state power requires us to account for the overall effect it may have on the state’s ability to reach and exert authority over all of its citizens. If decentralization affects not just the distribution but also the creation of state power then its use can no longer be thought of as fundamentally democratic, but instead must be understood as part of larger strategies of state power and control. This is particularly relevant when development organizations contemplate supporting decentralization policies in states that are less than fully democratic.
This is not to suggest, however, that decentralization is inherently normatively bad, either. There is great value to having a state that is effectively and efficiently governed throughout its territory, not only to central rulers but to citizens as well. Decentralization may be an important strategy for extending state power into stateless areas. If so, approaches that minimize the risk that decentralization poses to the center, through minimizing or at least managing agency costs, may be effective at creating more secure, effectively governed states.
Chapter 3

Paying for Policy: How Central Governments Get What They Want, Even When Institutions Say They Can’t

3.1 Introduction

If decentralization is a useful tool for expanding governance capacity, but only if central governments have access to strategies or institutions that give them influence over subnational decision-making, then better understanding the menu of control mechanisms and how they work is fundamental for understanding intergovernmental relations. While the previous chapter’s discussion of China addressed some examples of control mechanisms, from party structure to personnel policies, this chapter introduces an expanded discussion of one common control mechanism. Large-scale intergovernmental transfers are used to fund subnational governments across the world, and, while existing explanations for transfer levels have considered their political implications, there has been little consideration of their possible role as tools for exerting control or influence over subnational decisions or policies. The potential for intergovernmental transfers to serve as a tool for influencing subnational policy is only more important because not all states have the option to decide whether or not to decentralize in all policy areas. Central governments that face clearly (often constitutionally) delineated policy scopes have a limited ability to maintain centralization when control mechanisms are limited, but still wish to assert authority over subnational decision-making. This chapter argues that intergovernmental transfers,
in addition to serving as a general mechanism for central control, particularly fill this gap. After establishing the importance of intergovernmental transfers to governance and discussing existing explanations for intergovernmental transfer levels, this chapter develops a theory of how central governments use intergovernmental transfers to influence subnational policies and when this approach will be most worthwhile for central governments.

3.1.1 Intergovernmental Transfers and Policy Influence

Globally, central governments will transfer billions of dollars to provinces, states and other subnational units this year. Tax sharing, equalization transfers, block grants, shared cost programs—central governments have devised myriad mechanisms for moving central money to subnational leaders which, together, constitute a significant force in government spending and subnational financing. In Canada alone, for 2016-17, provinces and territories will receive $70.9 billion in major transfers from the federal government, or 79% of the Canadian government’s planned budgetary expenditures [66]. While the specific amounts vary, in most countries across the world, getting money from central leaders is important subnational business, and giving money to subnational leaders makes up an important central budget line.

But why do central leaders share their resources so freely? When central governments could, in theory, retain more control and get more credit by simply keeping more resources at their disposal, why do they transfer so much money to subnational units? This question becomes only more vexing when considering how often the central governments distributing funds have no control and little explicit influence over the subnational leaders spending them. Approximately 56% of subnational units have
at least one directly elected branch of government,¹ and these subnational leaders rely on their local constituencies to retain their positions, not the central government that is nonetheless handing them resources. Why would central governments continue to empower subnational leaders even when, institutionally, they have no means for ensuring compliance?

The argument I make in this paper is that intergovernmental transfers are used as a tool by central governments to buy policy from subnational leaders over whom they have limited direct control. Rather than neutrally transferring funds to ensure equitable and efficient delivery of services, or even using intergovernmental transfers as a way to reward co-partisans and supporters for their help and agreement, I suggest that central governments use transfer funds to convince reluctant subnational leaders to implement policies that the center prefers. This strategy can be successful because subnational leaders can then use these funds themselves to provide services and funding to supporters that make up for policies that fall outside of their preferred range. In this way, central governments can leverage central revenue powers into significant influence over subnational policy, even inducing policy convergence in areas where subnational leaders generally have the upper hand. Central governments transfer large amounts of central resources to subnational leaders over whom they have little formal influence because the money itself is influence.

This argument is important in several ways. First, it explains how extremely decentralized states, and even federations that have clearly delineated policy scopes between levels of government, can attain significant levels of policy convergence across states and provinces. Second, it sheds light on a useful tool for managing intergovernmental relations. Even when the relationship between subnational and central governments is

¹Based on Database of Political Institutions data on state/provincial elections for 143 countries [14]; this holds even for 44% of dictatorships (as defined by Cheibub, Gandhi and Vreeland [29])
conducted through clearly established institutional means, the inevitably incomplete nature of these contracts leads to continuing political negotiation over roles, responsibilities, and outcomes. This paper illuminates one tool that federal governments have found in the spaces between formal institutions, to help solve intergovernmental disagreements and smooth relations.

To better explain this argument and demonstrate its plausibility, after providing an overview of existing explanations for intergovernmental transfers I introduce a formal model of the relationship among central leaders, subnational leaders, and subnational constituencies which clarifies when and why we should expect to see central leaders paying subnational leaders to enact policies that more closely resemble central preferences. Following that, I draw out several hypotheses derived from this formal model and use both regression analysis and a qualitative exploration of intergovernmental relations in Canada to explore this relationship and provide evidence for these hypotheses.

3.2 Efficiency, Politics, or Policy

Existing explanations for central transfers to subnational governments focus on basic efficiency or equity concerns, or on the center’s tendency to use transfers as a political tool to shore up electoral support or reward supporters. While these may be factors in decision-making regarding central transfers, I argue that transfers may also be used as a means to influence subnational policy, in addition political outcomes and efficiency.

Many popular explanations for central transfers to subnational governments are intertwined with broader explanations of decentralization as driven by the desire for policy efficiency. Much of the earliest work on federalism and decentralization, including seminal arguments by Tiebout [146] about interjurisdictional competition;
by Oates [112] about heterogenous policy needs; and by Hayek [71] about information-gathering are motivated by the idea that central governments both do and should decentralize because doing so increases the efficiency of policy implementation. More modern arguments along the same lines are made by Weingast Jin et al. 84, Montinola et al. 109, Qian and Weingast 121, Weingast 159 who argues, with his coauthors, that the hand-tying element of decentralized policy-making preserves markets and increases economic growth. In all of these cases, central transfers would simply be in support of policy that has been decentralized for efficiency reasons. While this may be a driving factor for some transfers, in many cases the policy decentralization decision is made separately from the transfer decisions (often constitutionally), and if efficiency is the primary goal one would expect that revenue as well as expenditures would be decentralized.

Another argument along similar lines, supported by the existence of so-called equalization transfers in many states including Canada, China and Russia, is that central transfers are meant largely to equalize tax revenues and policy capabilities across regions with different revenue and tax bases. While this no doubt drives some amount of transfer spending, a number of studies, including this one, find that non need-based variables nonetheless matter in estimating where central transfers are spent and that, in some cases, need-based variables do a particularly poor job of explaining the recipients of central transfers (see Treisman [150], for example). It seems both clear and predictable that most states distribute central transfers not just based on neutral efficiency criteria but also based on some sort of political process.

Other approaches might suggest that transfers to subnational units are driven either by ideological considerations, with one party or part of the ideological spectrum committed to more decentralized governance, or by social choice considerations, with central leaders distributing transfers as a way to lock in preferred policies against
the prospect of future central changes. These considerations might explain overall levels of intergovernmental transfers, as central leaders ideologically committed to decentralized governance or fearful of future central policy changes provide higher levels of intergovernmental transfers, but they provide little insight to how these transfers should be distributed across subnational units.

Generally, existing explanations for central transfers that do take into account political processes focus almost entirely on the political goals and imperatives for central leaders without considering the possibility of central policy goals. Most explanations along this vein consider the possibility that central leaders use subnational transfers as a way to shore up support and votes, either by targeting areas where their support is greatest or by targeting areas with large numbers of swing voters (see Johansson [85], Simon-Cosano Simon-Cosano et al. 136, Khemani Khemani 89, and Grossman Grossman 68 for a variety of explanations along these lines). While political imperatives absolutely motivate central decision-making, policy outcomes also matter to central leaders, if only because these have significant political implications. Central leaders may or may not have independent policy goals but their role within a coalition or party, and within the government, certainly depends on delivering benefits to party or coalition members. In some contexts direct rents or monetary transfers may be sufficient, but in many contexts parties and coalitions expect leaders to successfully achieve certain types of policy outcomes. Thus, central leaders are often deeply concerned with bringing about particular policy outcomes. This study considers the possibility, not evident in this existing literature, that central leaders use transfers to buy policy, not just votes.

There is some evidence that, contrary to the studies cited above, central transfers to subnational units are motivated significantly by disagreement rather than by agreement; that is, several studies have suggested that the amount of central trans-
fers to a particular region is driven by the region’s amount of leverage or ability to demand transfers [11, 118, 119, 150]. Most of these focus on institutional markers of leverage like the number of representatives in parliament or the professionalization of the regional government, but don’t take into account the ways in which genuine and sustained policy disagreement may create leverage that is separate from the institutional channels for exerting leverage. Explanations for federal and decentralized governance that focus on its ability to accommodate difference, particularly ethnic minorities (see, especially, Hechter [73]), acknowledge the leverage that fundamental difference may give to subnational units but do not provide a clear account of how central governments may nonetheless influence subnational policy. In general, concern for policy outcomes, presumably the results of these transfers, is missing in this literature as well. One exception is Treisman’s [150] study which found, among other things, that Russian regions in the early and mid-1990s were likely to get higher levels of central transfers if they had previously indicated a commitment to secession from the Russian Federation. While preferences over whether a region remains in a federation or parts from it are undoubtedly particularly important policy questions, and will prove important in the Canadian case discussed below, this approach still does not consider any other, less extreme, policy arenas. I contend that the central government may use central transfers to influence a wide variety of policy areas, including but not limited to decisions over secession.

At the very least, while efficiency and naked political concerns may very well influence the distribution of central transfers to subnational units in a variety of cases, I make the case that central governments also consider preferences over policy outcomes, across an entire spectrum of policy arenas, in making decisions regarding transfers.
To bring preferences over policy outcomes into discussions about central transfers, and to help in considering competing policy preferences over a single policy space I adapt a spatial modeling approach to preferences over the policy space, based on Epstein and O’Halloran’s work [47, 48], which itself draws on work on bureaucratic delegation (illuminating issues of competing policy preferences) [158], [161]. This also requires a consideration of how mechanisms for monitoring, incentives, discretion and ex-ante controls may constrain both levels of policy-makers, as explored in Miller [105], Crawford and Sobel [36], Dessein [38], Gailmard and Patty [58], Bendor and Meirowitz [17], and Volden [155].

3.3 Theory: Central Spending as Policy Influence

While we assume that political leaders and their supporters, both central and subnational, may have preferences over policy outcomes, citizenries can vary widely across space in ideology, policy preferences, even ethnicity and language. If central leaders do have preferences over policy outcomes, they should be expected to want these implemented throughout the country, either because of sincere policy commitments or to better respond to their supporters’ preferences. Subnational leaders, on the other hand, particularly those who are elected or selected through local processes, should be expected to choose policies that reflect the preferences of their subnational constituency, independent of central preferences. In cases where subnational leaders are autonomous from central oversight—where central leaders are deprived of explicit institutional mechanisms for shaping subnational policies—we should expect central governments to seek to employ less formal means of influencing policy (or, in centralized policy areas, to be reluctant to decentralize). I argue that fiscal transfers are one tool that central governments use to influence subnational policy, using ambiguity in
institutions of intergovernmental financing to substitute for the lack of formal institutions for influencing subnational policy. This allows for central influence in subnational decision-making, and for convergence in subnational policy, even in decentralized or federal states.

To create a clear understanding of how central leaders may use fiscal transfers to shift subnational policy outcomes, I develop a formal model of the relationship between central and subnational leaders. I argue that central leaders can use fiscal transfers to essentially “buy” policy from subnational leaders, who use the increased revenue to placate supporters and retain power, despite policy that diverges from subnational preferences. I explore this dynamic using two different game forms, for cases where the division of powers between central and subnational leaders is well-established, as in many federal states, and for cases where central leaders have a choice as to whether or not to decentralize. I use a basic unidimensional spatial modeling approach to model policy preferences and explore this dynamic.

Each of the game forms is based on a spatial model examining the interactions among three players: the center (C), subnational leaders (SL), and a subnational electorate (or selectorate) (S). For the first game form, decision-making proceeds as indicated in figure 1: first, central leaders decide whether or not to exert influence over subnational decision-making; following that, a policy \( p^* \) is chosen by SL; after a policy is chosen, the final policy outcome \( x \) is revealed to central leaders and the subnational electorate; last, S, the subnational selectorate will decide whether to retain the agent (SL).
I assume that subnational leaders, $SL$, hold very simple preferences: they prefer to stay in power.\textsuperscript{2} While subnational leaders have a variety of preferences for policy and consumption, the realization of any of these preferences is dependent on retaining power over policy and resources. Subnational leaders wish to maximize their likelihood of retaining their positions by maximizing the subnational electorate’s utility.

Subnational leaders do this by taking into account subnational electorates’ ideal points along the policy space, defined as $X = \mathbb{R}$, the real line. Without loss of generality, I assume the center’s ideal point is fixed at $C = 0$, while the subnational electorate has an ideal point of $S > 0$. The policy space and these ideal points are illustrated in figure 2. Following Epstein and O’Halloran \cite{EpsteinO78,EPF19} and other standard delegation models, I assume that preferences for $C$ and $S$ are quadratic in final policy outcomes $x$:

\begin{align*}
UC(x) &= -(x - C)^2 = -x^2 \\
US(x) &= -(x - S)^2
\end{align*}

\subsection*{3.3.1 Model Form 1: Buying Policies}

In many states, the center maintains significant financial influence over subnational units. Even in federal states and those that are most politically and fiscally decentralized, subnational units are often extremely dependent on the central government.

\textsuperscript{2}While this model is inspired by the agency discretion model by Epstein and O’Halloran \cite{Epstein78}, there are several significant departures from this model. First, the addition of a subnational electorate, making subnational leaders beholden to two sets of interests, is a divergence; in the canonical model, agency preferences are simply their own. Relatedly, in Epstein and O’Halloran’s \cite{Epstein78} model the result of a policy that diverges from Congressional preferences too significantly is simply that Congress rejects the proposed policy, reverting policy to the Congressional ideal point; in the model presented here an exceptionally divergent policy results in the intermediary—in this case the subnational leader—being removed from power.
to support subnational governments. The vast majority of states provide some limits, whether statutory or constitutional, on how subnational units structure the taxes and fees that allow them to collect revenue for themselves (own-source revenue). This may include specific limits on what sorts of taxes or fees may be collected at both local and provincial levels, as well as formulas for dividing up shared sources of revenue, including most tax sources as well as resource revenues. Central governments may also restrict the extent to which subnational units can borrow, using formal controls to further reduce access to debt markets that many subnational units would have trouble leveraging in the first place. Limited subnational access to resources can create a dynamic in which subnational leaders need central support to enact policies, even when subnational leaders are formally accountable only to subnational interests.

This dependence allows central leaders to exert several forms of fiscal leverage over subnational policies. Much of this leverage comes in the form of direct budgetary grants from central to subnational coffers. Central decisions about and allocation of these grants have the potential to either reward or hamstring subnational units as they pursue and implement policies, particularly where provinces rely on central transfers to make up large portions of their budgets. Central leaders may find additional sources of leverage through the allocation of central investment, particularly in infrastructure, the creation of policy programs intended to be funded centrally and administered subnationally, as well as more direct policy influence through strings-attached funding.

In these situations, subnational leaders are put in the difficult situation of managing competing demands from central and subnational interests. While subnational interests determine the political fates of subnational leaders, central pressures can provide incentives to deviate from subnational preferences and, at times, limit subnational leaders’ ability to set policy optimally for subnational interests. How do central leaders use this leverage, and how do these strategies affect subnational policy
outcomes? On the one hand, central governments could, in theory, demand policy outcomes that deviate from central ideal points by no more than a specified amount, entirely holding resources hostage to ensure compliance; this would allow them to both capture some of the informational advantages of delegation while also preventing subnational leaders from complying with particularly extreme subnational preferences. However, not only would the courts almost certainly strike down this strategy in strongly-institutionalized states, it would also be self-defeating. Making these demands would effectively sever any ties subnational leaders have with any group that has the ability to sanction them—their likelihood of continuing in office would be completely divorced from their policy decisions. In this instance, subnational policy choices would become unconstrained and unpredictable, making delegation a dangerous choice. Barring that, then, I suggest that central governments may use their fiscal influence to affect policy choices, employing discretionary grants and investment to “buy” policy from subnational leaders, who then pass these benefits on to subnational supporters and elites, essentially replacing existing formal institutional relationships with informal reciprocal patronage networks stretching from central leaders to far-flung constituents.

In this interaction, the center, $C$, taking into account subnational policy preferences and the likely cost of inducing subnational leaders to adjust policy outcomes, decides on the existence and value of $\lambda$, a limit the center, $C$, places on policy outcomes. Based on this choice, the subnational leader, $SL$, chooses a policy $p^*$, which corresponds to a policy outcome, $x$. The subnational constituency, $S$, decides whether or not to retain the subnational leader, $SL$, in her position, and all three players receive their payoffs. In addition to the possible imposition of $\lambda$ as a limit to subnational policy choices, this interaction also incorporates an assumption that the center will compensate subnational leaders for complying with this limit through grants or
investments to make up for the subnational utility lost by the policy change of $S - \lambda$. The addition of $\lambda$ to the policy space is illustrated in figure 3.\(^3\)

Introducing fiscal compensation for policy outcomes changes both central and subnational utility functions. Now, not only do players derive utility from the correspondence of policy outcomes with their ideal points, they also, independently, derive (or lose) utility from the addition (or subtraction) of this compensation. Note that the utility increase experienced by the subnational electorate, $\phi_s$, is not necessarily the same as the utility decrease experience by the center, $\phi_c$ even for the same compensation package. Because of differences in resource availability and differing intensities of preferences around policy, these may not be the same value. The revised utility functions, based on ideal points ($C$ and $S$), policy outcomes ($x$) and utility from compensation ($\phi_c$ and $\phi_s$) are:

\[
U_C(x) = -(x - C)^2 - \phi_c = -x^2 - \phi_c
\]

\[
U_S(x) = -(x - S)^2 + \phi_s.
\]

**Results**

Using backward induction as the equilibrium concept, there are several possible equilibria, depending on the values of $S$ and $\phi_s$.\(^4\) If $S$ is sufficiently small (if $S < \sqrt{\phi_c^2 + \lambda}$), then in equilibrium the subnational electorate will retain the subnational leaders; the subnational leaders will set policy such that $x = S$; and central leaders will refrain from imposing a policy limit.

\(^3\)The addition of compensation for complying with central limits is another divergence from the Epstein and O’Halloran [47] model. Because that approach models a direct principal-agent relationship such compensation has no place; in this case, the principal-agent relationship between central and subnational leaders is severed and central leaders must devise some inducement for encouraging subnational compliance.

\(^4\)See Appendix A for all calculations for this section.
If $S$ is larger, however, determining the equilibrium becomes more complicated. Where $S$ is large but the value of compensation central leaders are willing to offer to subnational leaders is not sufficient then the center’s equilibrium strategy will be to set a policy limit such that $\lambda < \sqrt{S^2 - \phi_c}$. However, subnational leaders will, in equilibrium, set policy such that $x = S$ and the subnational electorate will retain the subnational leaders. In this equilibrium, subnational preferences diverge significantly enough that central leaders are willing to offer compensation to influence policy but this policy is more valuable to subnational leaders than to central leaders. Central leaders are thus unsuccessful in influencing policy. If, however, both $S$ and $\phi_s$ are sufficiently large, in equilibrium central leaders will set a policy limit and offer compensation, subnational leaders will set policy in accordance with this limit, and the subnational electorate will retain the subnational leadership.

However, because this model does not assume that the compensation offered by central leaders represents the same value or utility to central and subnational leaders, working through the model to better understand the comparative statics involved may be more illuminating than the equilibria themselves.

**Comparative Statics**

Working through the backward induction described above, subnational interests will only retain $SL$ as subnational leader if policy outcomes correspond with the subnational ideal point ($x = S$) or if policy outcomes correspond with the centrally-imposed limit ($x = \lambda$) and the compensation from central budgets is large enough to make up for the policy losses. Under this model, the subnational electorate will retain subnational leaders who comply with central policy limits only if $\phi_s \geq (\lambda - S)^2$.

---

This compensation, $\phi_c$, must be less than $S^2 - \lambda^2$ for central leaders to be willing to offer it.

If $\phi_s$, or the value of this compensation to the subnational electorate is less than $\lambda - S^2$. 

---
In choosing a policy, then, subnational leaders will be indifferent between setting policy \((p^*)\) such that \(x = S\) and setting policy such that \(x = \lambda\), so long as \(\phi_s \geq (\lambda - S)^2\); either course will allow them to retain their positions. Indeed, if we accept the reasonable assumption that subnational leaders will be able to capture any surplus payment from the center, so long as the compensation offered, \(\phi_s\), allows for increased utility even trivially larger than \((\lambda - S)^2\) subnational leaders will strictly prefer to set policy to correspond with central limits (such that \(x = \lambda\)), rather than subnational ideal points.

Given this, central leaders will choose whether to impose a policy limit and offer compensation in part by weighing the utility cost of the compensation offered against the increased utility derived from policy closer to the central ideal point. If subnational preferences are close enough to the central ideal point, central leaders will prefer to simply allow subnational leaders to make policy without compensating them. As subnational preferences increasingly diverge from central preferences, however, (when \(S > \sqrt{\phi_c^2 + \lambda}\)) central leaders become willing to offer compensation for policy set at a policy limit \((\lambda)\) closer to the center’s ideal point, so long as the utility loss from the compensation offered is sufficiently low (so long as \(\phi_c < S^2 - \lambda^2\)).

Another way of thinking about this is that central leaders continue to be willing to set policy limits and offer compensation so long as the price of policy (the utility loss due to the compensation provided, relative to the utility increase because of the policy change) is sufficiently low. Note that the center’s tendency to use fiscal compensation only in circumstances where subnational preferences are sufficiently far from central preferences leads to the conclusion that subnational units that diverge ideologically from the center are more likely to profit from this dynamic than those we would traditionally think of as being central allies.
In short, this model suggests that central leaders are more likely to use fiscal transfers as leverage to buy policy when they can get the most "bang for their buck," for example when central resources are relatively plentiful or when subnational resources are relatively scarce and, more surprisingly, that subnational units with greater political differences from central leaders are likely to receive more money from this dynamic than those that more closely agree with central preferences.

### 3.3.2 Model Form 2: Buying Policies with a Decentralization Decision

With a small adjustment, this model can also be used to explore how using fiscal transfers as a form of leverage can affect not only subnational policies but also central decision-making regarding decentralization. When subnational leaders have clear jurisdiction over policy areas and are responsible only to subnational supporters and not to central leaders (as in the first game form), it follows that central leaders would reach for whatever leverage they have—in this case, fiscal leverage. When subnational leaders are responsible only to subnational supporters, but central leaders can choose whether or not to delegate policy-making authority, should fiscal leverage still play a role, or will central leaders simply prefer to administer policies directly? With reasonable assumptions regarding the informational or efficiency advantages of decentralization, this model suggests that there remains a place for fiscal leverage in the center’s intergovernmental relations toolkit.

Again, this game form models policy preferences along the policy space, defined as \( X = \mathbb{R} \), the real line, with the center’s ideal point fixed at \( C = 0 \), and the subnational electorate’s ideal point at \( S > 0 \). Both central and subnational utility functions also remain the same. This game form, however, introduces two innovations; first, central leaders get an initial decision as to whether to delegate policy-making authority and, second, the differences between central and subnational policy-making abilities are
approximated by the introduction of a new random term, \( \omega \), a realized state of the world that affects policy outcomes. In this case, the final policy outcome, \( x \), depends both on the chosen policy \( p^* \) and the state of the world (\( \omega \)), such that \( x = p + \omega \). A sample value of \( \omega \), along with ideal points for \( C \) and \( S \), are illustrated in figure 4. I assume the state of the world, \( \omega \), to be drawn from a uniform probability distribution such that \( \omega \sim U[-1, 1] \). At the point when a policy is chosen, subnational leaders are fully informed of \( \omega \), while the center is only aware of the probability distribution from which \( \omega \) is drawn. If the center declines to delegate to subnational leaders, the final policy outcome will simply be \( x = \omega \). For this game form, decision-making proceeds as indicated in figure 5: first, central leaders decide whether or not to delegate decision-making to subnational leaders and, if they choose to delegate, whether to impose a policy limit; following that, a policy is chosen, either by \( C \) or by \( SL \); after a policy is chosen, the state of the world (\( \omega \)) as well as the final policy outcome (\( x \)) is revealed to all players; last, \( S \) will decide whether to retain the agent (\( SL \)).

In bureaucratic delegation models derived from American politics, the inclusion of \( \omega \) suggests *ex ante* uncertainty as to conditions along with the advantages of expertise in policy-making. Agents can gather information and adjust to the realized values of \( \omega \), reducing uncertainty in outcomes, while principals can only react to expectations about \( \omega \). In this application, variations in the state of the world serve a similar purpose, but also incorporate variation in policy conditions across subnational units. Central leaders are simultaneously playing this delegation game with (and creating policy for) perhaps dozens of subnational units in each period. The state of the world

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\(^7\) The initial decentralization decision is an additional point where this model diverges from the Epstein and O’Halloran [47] model on which it is based. In that model agencies are assumed to have the ability to make policy decisions, though these policies may subsequently be rejected by Congress; in this case, central leaders may decide to retain decision-making for themselves but cannot adjust policy after the fact.
for each subnational unit will vary, suggesting that for each subnational unit $\omega$ is determined by a separate draw. The best central leaders can do is to set a single policy at their ideal point ($C = 0$), while subnational leaders may each adjust to their individually realized values of $\omega$.

Because subnational leaders have the ability to gather information and perfectly adjust policy to the state of the world, $\omega$, these adjustments do not change incentives or decision-making for subnational leaders or subnational selectorates. Subnational leaders still prefer to remain in power, and do so by maximizing subnational utility. Similarly, subnational selectorates are likely to retain subnational leaders so long as subnational policy is set at the subnational ideal point or compensation from the center is sufficient to make up for the loss of utility from a deviation from subnational policy preferences. Thus, as above, subnational selectorates will allow policy set at the center’s policy limit so long as $\phi_s \geq (\lambda - S)^2$, and subnational leaders will set policy accordingly if given the chance.

Given these preferences, how do central leaders decide whether or not to delegate and, if they do delegate, whether or not to set policy limits? If subnational preferences diverge from central preferences, will central leaders be better off simply retaining policy authority? Central leaders will choose to delegate with a policy limit only if this makes them better off than both pure delegation and non-delegation. The decision between delegation with and without policy limits will be made as above: given delegation, central leaders will delegate with a policy limit and related compensation only if subnational preferences diverge sufficiently from central preferences and the price of policy is sufficiently low. In deciding whether to delegate decision-making at all, central leaders must compare their expected utility, given the randomness inherent
in the state of the world, $\omega$, with the utility that they would gain from policy set at subnational ideal points, or at a policy limit while taking compensation into account.\(^8\)

Working through these comparisons, central leaders will prefer to retain policy-making authority only if subnational preferences diverge significantly from central preferences (given the assumed distribution for $\omega$, only if the subnational ideal point, $S$, is greater than $\sqrt{\frac{2}{3}}$). For subnational ideal points that are closer to the center’s ideal point relative to the price of policy (where $S < \sqrt{\frac{\phi^2 c}{(\lambda_1^2 + \lambda)}}$), central leaders prefer pure delegation because the costs of compensation outweigh the advantages of the preferred policy outcome. For middle ranges of subnational ideal points, however (and particularly when the price of policy is low), fiscal leverage remains an attractive tool for central leaders. Even in cases where central leaders could simply decline to delegate and choose to set policy themselves, the availability of fiscal leverage allows central leaders to gain advantages from decentralization even when subnational leaders are independent and subnational preferences diverge from central preferences. While the ability to choose whether or not to delegate reduces the range in which central leaders will use transfers to influence policy, it remains a viable option for inducing policy convergence, even in more centralized states.\(^9\)

### 3.4 Empirical Strategy

How would we know whether central transfers to subnational governments represent simply an efficient allocation of resources or a means of rewarding supporters or,

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\(^8\)All calculations for this section are also available in Appendix A.

\(^9\)In this version of the model, the equilibria for values of $S$ such that $S < \sqrt{\frac{2}{3}}$ are identical to the equilibria described above. For values of $S$ greater than this, in equilibrium central leaders will retain policy-making powers, subnational leaders will no longer have a decision to make, and subnational electorates will dismiss subnational leaders because policy will vary from subnational preferences without sufficient (any) compensation.
instead, constitute a means of buying policy from diverse subnational polities? First, the model above suggests several implications that could help adjudicate between the explanation I suggest here and alternative theories. In addition, a careful examination of strategies and statements around decentralization and fiscal transfer decisions can provide specific support.

The clearest indicator that fiscal transfers are intended as a means of central influence on subnational policy would be who benefits most from central transfers. If transfers are intended to support efficiency in revenue collection and policy administration, I would expect the political inclinations of subnational units to have little relationship with central transfers. If fiscal transfers are used primarily as part of the party patronage system to reward supporters, then subnational units headed by co-partisans of central leaders would be expected to gain disproportionately from central transfers. If, on the other hand, central leaders use fiscal transfers to influence subnational policy, the model introduced here suggests that subnational units headed by co-partisans of central leaders should receive less in the way of fiscal transfers than do subnational units whose leaders and preferences diverge more sharply from the center’s—why buy policy when you can get it for free? Simply put:

**Hypothesis 1.** *Having subnational leadership from the same party as central leadership is associated with lower levels of central fiscal transfers, all else equal.*

While this hypothesis distinguishes the theory presented here from theories that assume political gain through directing money to supporters or pouring money into strongholds, it does not clearly distinguish it from theories that focus on the concentration of swing voters or other more nuanced political motivations. However, any changes in transfer levels based on electoral motivations should have a strong relationship with the timing of elections; transfers that are meant to influence policy rather
than political outcomes, on the other hand, should not be time-dependent. Thus, when testing this hypothesis I will also test whether this relationship exists when accounting for time effects. This hypothesis will be explicitly tested in the quantitative analysis below, with additional context and process evidence in the qualitative analysis.

In addition, while transfers motivated by efficiency or by rewarding supporters should not necessarily be associated with particular types of subnational polices, transfers motivated by influencing subnational policy obviously should. Without clear means of central influence, in decentralized states subnational policy and subnational policy outcomes should be expected to diverge insofar as subnational preferences diverge. The theory presented here suggests that central leaders may use fiscal transfers to mitigate this effect. In that case:

**Hypothesis 2.** *All else equal, central transfers are associated with policy convergence across subnational units.*

This should be expected to hold across time (as transfers increase, policy should be expected to converge) and across states (controlling for preference divergence, states with higher transfers should have more uniform policy than those with smaller transfers). While the empirical strategy for this paper precludes testing this hypothesis cross-nationally, its effects across time will be addressed in the qualitative evidence below.

Last, while this presents more measurement challenges, the “price” of policy should also be expected to affect both transfer levels and policy outcomes if the above model effectively represents the dynamic between central and subnational leaders. When policy is more costly to central leaders, whether because of strong salience for subnational units (any change in policy represents a relatively extreme utility loss to
subnational units, necessitating correspondingly extreme compensation—often the case for language and cultural policy) or because of a tight budget constraint, central leaders will moderate their efforts to influence policy. Instead they will either accept somewhat more divergent policy outcomes or refuse to engage in compensation at all. This dynamic leads to the following relationship:

**Hypothesis 3.** *When policy is more costly, transfers will be smaller, subnational policy will be more divergent from central preferences, or both.*

This hypothesis will also be considered in the qualitative evidence presented here.

While the model suggests that the mechanism of paying subnational units for the center’s preferred policy outcomes should be in operation in a wide variety of states, to clearly isolate the dynamics at play here, which are largely intra-state and subnational, I will test these implications using both time-series quantitative and historical qualitative data from Canada. Canada is a particularly good case for several reasons. First, while it is a large and generally well-functioning and well-institutionalized federation, constitutional questions have continued to be renegotiated through the present day. This, along with Canada’s bilingual and multicultural character (leading to significant preference divergence across subnational units), means that there has been significant variation in Canada’s relationships to its constituent units both across space and across time. However, because of Canada’s status as a wealthy, institutionalized democracy, many of these negotiations and dynamics have been extensively reported as well as unusually candid, creating a rich historical record to reference. Working through Canada’s complex history of intergovernmental relations is also a compelling reminder of the fundamentally political dynamics driving intergovernmental relations in well-institutionalized federations and poorly-institutionalized developing states alike.
This empirical exploration will begin with a quantitative test of the relationship between Canadian subnational units’ preferences and transfers, explicitly testing whether co-partisanship affects the level of intergovernmental transfers to each province. This quantitative section will focus on evaluating hypothesis one and establishing the plausibility of the argument that intergovernmental transfers may be politically motivated. Following that, I provide an examination of Ottawa’s negotiations with subnational leaders over policy and constitutional issues, focusing primarily on the Meech Lake negotiations and the Canadian federal spending power. I use this examination to explore Ottawa’s motivations in distributing intergovernmental transfers as well as the policy outcomes of these transfers. This qualitative analysis will provide context and additional support for hypothesis one, as well as introduce evidence in support of hypothesis two (that federal use of intergovernmental transfers leads to policy convergence) and hypothesis three (the price of policy affects the extent to which the central government is willing to engage in purchasing policy).

3.5 Canadian Provincial Leadership and Fiscal Transfers

3.5.1 Data

In this section, I use regression analysis to determine what type of political relationship there may be in Canadian politics between fiscal transfers and subnational political preferences. This serves as a basis for the subsequent qualitative analysis exploring the dynamics of the politics at work Canadian intergovernmental relations in specific instances. The quantitative analysis will specifically test hypothesis one: that subnational units that have policy preferences similar to the center’s, indicated by election of a co-partisan of the central leadership, will receive lower levels of fiscal transfers than those with policy preferences that are more distinct from the center’s.
If this is the case, this would suggest that central leaders are, in fact, attempting to induce their preferred policy in provinces that would otherwise be unlikely to choose such policies on their own. In contrast, if fiscal transfers were intended to simply reallocate resources to allow for subnational policy-making, there would be no expected relationship between transfers and co-partisanship; and if, instead, transfers were intended to reward supporters rather than inducing particular policies, I would expect a positive relationship between fiscal transfers and co-partisanship of central and subnational leaders.

I test this hypothesis using time-series data for all ten Canadian provinces from 1961-2009. The dependent variable for these models is the amount in per capita federal transfers received by each province in each year. Data on population as well as transfers are from the official Canadian statistics service [137, 138, 139, 140]. Over this time period, transfers per capita range from 39 CAD (Quebec in 1961) to 7823 CAD (Newfoundland and Labrador in 2005), with a mean of 1125 CAD and a median of 766 CAD. The independent variable of interest is a binary variable indicating whether the province’s premier in that year was of the same political party as the Canadian Prime Minister. Over this time period, individual provincial premiers shared a political party with the Prime Minister in 28.98% of province-years. Some models reported here also include an indicator of whether or not the Prime Minister was from the Liberal party, to control for the effect of the center’s political preferences, as well as a measure of the provincial unemployment rate, to control for the effects of local economic conditions.

The regression results for these models may be found in tables 1 and 2. All of the regressions presented are GLS pooled time-series cross-sectional models. For all

10For models that include unemployment rates, the data runs from 1976-2009
models, I present specifications with and without clustered standard errors. In addition, all models are presented using province fixed-effects, and, for each model, I also present specifications with and without two-way (year) fixed effects.

3.5.2 Results and Discussion

As indicated in the results tables, having a provincial premier that comes from the same party as the Prime Minister is consistently and statistically significantly associated with lower per-capita federal transfers. While the effect size varies based on the model specification, it remains large and statistically significant when the provincial unemployment rate and the prime minister’s partisan affiliation are controlled for, when clustered standard errors are included, and when using year fixed effects as well as province fixed effects.

The effect seems to be substantively significant as well; based on the models presented here, the simple fact of electing a provincial premier that is a co-partisan of the Prime Minister can reduce a province’s receipts from federal transfers by between 137 CAD and 429 CAD per person, or between 18% and 56% of the mean per capita transfer amount. For even the smallest province in 2009, Prince Edward Island, that amounts to a potential loss of more than 19 million CAD using the most conservative estimate. For a larger province like British Columbia (still only the third-largest province) the budgetary effect could be on the order of 603.5 million CAD. In both cases, this represents more than 1% of total provincial revenues, a modest amount relative to overall provincial budgets but significant in terms of raw spending power and discretionary funds.

11While clustering may be advisable because errors are likely to be correlated by province, clustered standard errors with a small number of clusters may be downward biased [170]; thus I present models with both clustered and unclustered errors.

12Hausman tests indicate that fixed effects are advisable
<table>
<thead>
<tr>
<th>Table 3.1: Co-partisanship and Fiscal Transfers</th>
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<tbody>
<tr>
<td>(1)                            (2)               (3)              (4)</td>
</tr>
<tr>
<td>Per capita transfers       Per capita transfers   Per capita transfers   Per capita transfers</td>
</tr>
<tr>
<td>Same party                   -429.4***            -429.4**            -257.7**             -257.7*</td>
</tr>
<tr>
<td>(99.68)              (161.7)              (102.2)              (133.9)</td>
</tr>
<tr>
<td>Unemployment rate            -94.59***            -94.59**            (21.49)              (32.78)</td>
</tr>
<tr>
<td>Liberal Party PM             -427.8***            -427.8***           (85.14)              (70.56)</td>
</tr>
<tr>
<td>Constant                     1249.2***            1249.2***           2773.4***           2773.4***</td>
</tr>
<tr>
<td>(51.87)              (46.87)              (219.8)             (335.3)</td>
</tr>
<tr>
<td>Observations                 490                  490                340                340</td>
</tr>
</tbody>
</table>

Standard errors in parentheses
All models include province fixed effects
Models 2 and 4 include standard errors clustered by province
* $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$
Table 3.2: Co-partisanship and Fiscal Transfers with Two-way Fixed Effects

<table>
<thead>
<tr>
<th></th>
<th>(1)</th>
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<tr>
<td></td>
<td>Per capita transfers</td>
<td>Per capita transfers</td>
</tr>
<tr>
<td>Same party</td>
<td>-137.2*</td>
<td>-137.2*</td>
</tr>
<tr>
<td></td>
<td>(72.66)</td>
<td>(74.32)</td>
</tr>
<tr>
<td>Unemployment rate</td>
<td>43.14</td>
<td>43.14</td>
</tr>
<tr>
<td></td>
<td>(26.61)</td>
<td>(47.75)</td>
</tr>
<tr>
<td>Liberal Party PM</td>
<td>-2518.2***</td>
<td>-2518.2***</td>
</tr>
<tr>
<td></td>
<td>(220.2)</td>
<td>(503.4)</td>
</tr>
<tr>
<td>Constant</td>
<td>2728.7***</td>
<td>2728.7***</td>
</tr>
<tr>
<td></td>
<td>(278.6)</td>
<td>(582.2)</td>
</tr>
<tr>
<td>Observations</td>
<td>340</td>
<td>340</td>
</tr>
</tbody>
</table>

Standard errors in parentheses
Both models include province fixed effects and year fixed effects
Model 2 includes standard errors clustered by province
* p < 0.1, ** p < 0.05, *** p < 0.01

While it would be reasonable to worry that Quebec or Ontario might be driving these results because of their size, Quebec’s unique role in the federation, or Ontario’s generally close relationship to the central government, the models continue to perform well both when Quebec and when Ontario are omitted. Overall, the data seem to indicate a strong negative relationship between fiscal transfers and provincial premiers’ co-partisanship with the Prime Minister, and one that could have substantively noticeable effects. Increased spending in politically distant provinces could also be driven by electoral concerns, as a means of trying to convince voters. However, if this were the case we would expect these expenditures to be concentrated immediately prior to elections; for expenditures meant to influence policy decisions, however, we should expect no such time effects. The fact that the relationship remains in the time

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13These results are unreported here, though are available upon request.
fixed-effects models, then, suggests that this relationship is driven at least partially by policy preferences rather than being driven entirely by electoral concerns.

This suggests that, regardless of the formulas or mechanisms Canada uses to distribute fiscal transfers, there is a fundamentally political dynamic at work, and one that serves a purpose other than rewarding supporters of the central government. Similarly, the fact that co-partisanship has this effect indicates that any policy convergence that is being induced through central funding mechanisms operates not just through strings-attached funding, but through a process that is more opaque than that. The data suggest that, for provinces, political disagreement with the center will induce Ottawa to transfer larger amounts of central money than will political agreement; I suggest that this is driven by a dynamic in which Ottawa is using its spending power to induce provinces to adopt policies that are closer to what it would prefer than the province would otherwise adopt. While the quantitative evidence clearly distinguishes this situation from a world in which central leaders use transfers only for efficiency or direct patronage purposes, three questions remain: first, is this a strategy that the center is consciously pursuing, or one that is somehow baked into the bureaucratic and administrative procedures governing fiscal transfers? Second, does this strategy effectively induce some measure of policy convergence? And, last, does Ottawa’s willingness to engage in these strategies depend on the costliness of policy? While none of these questions is easy to answer conclusively, an examination of the historical record can suggest some plausible answers. The following section brings context to the broad quantitative results presented here by exploring the long-term intergovernmental and constitutional negotiations between Ottawa and the provinces, with a particular focus on debates regarding the Meech Lake Accords and the federal spending power.
3.6 THE DYNAMICS OF CANADIAN INTERGOVERNMENTAL RELATIONS

Between 1927 and the late 1990s, Canada was engaged in near-constant constitutional negotiations, many of which were focused on fundamental issues of intergovernmental relations. These well-documented negotiations have provided significant insight into the role of intergovernmental transfers in Canada, including Ottawa’s use of intergovernmental transfers to influence provincial policies. The evidence reveals that both Ottawa and the provinces see federal intergovernmental spending as an important tool for influencing provincial policy, though opinions on the appropriateness or desirability of this tool vary. Disagreements over the proper application of federal spending in the provinces support the hypothesis that the central government uses intergovernmental transfers as a means of leverage for coaxing preferred policies from reluctant subnational leaders. Furthermore, Ottawa’s success in creating broadly consistent social welfare policies across Canada, despite its reliance on provincial governments to do so, supports the hypothesis that increased or expanded use of intergovernmental transfers increases policy congruence within a state. Last, the complications that Canada has occasionally faced in using intergovernmental transfers to induce policy convergence, both in terms of the steep price that Quebec places on policy and opportunity costs that create a high price for policy during recessions, support the hypothesis that when policy is costly central governments will likely be less successful in inducing policy convergence.

This section engages the history of Canadian constitutional reform and negotiation to demonstrate the role of intergovernmental relations in Canada and the extent to which these patterns support the theory presented here. I begin with an overview of the Canadian Constitution and its framework for intergovernmental relations. Following that, I describe the tools that Ottawa has developed for distributing
intergovernmental transfers and influencing provincial policy, along with the disagreements that provinces have expressed regarding these tools; this discussion will focus primarily on the negotiations surrounding the Meech Lake accords, which provided an unusually clear understanding of the positions and points of disagreement on the federal spending power. Last, I explicitly address some of the implications of these issues, particularly how they relate to the theory and hypotheses presented here.

3.6.1 Framework of Canadian Constitution and Intergovernmental Relations

Until 1982, the bulk of the Canadian constitutional understanding was vested in the British North America Act of 1867, which brought together the colonies of Canada, Nova Scotia, and New Brunswick into a federated union,\(^\text{14}\) “with a Constitution similar in principle to that of the United Kingdom” \[80, p.11\]. This document set out the basic distribution of powers between the federal and provincial governments as well as parts of the provincial constitutions and elements of language and denominational school rights critical to the relationship between English-speaking and francophone Canada \[80, p.10-11\]. While the British North America Act included provisions allowing provincial legislatures to amend their own constitution, outside of a few specific areas there was no such provision for Canada as a whole. Any changes to, or even clarifications of, the Canadian constitution had to be requested of the British Parliament. In addition, while Canada was allowed to establish a supreme court—and did so, in 1875—the Judicial Committee of the Privy Council remained the final arbiter of Canadian law, and decided any jurisdictional disputes between the federal and provincial governments through Canada’s formative years \[80, p.13\].

\(^{14}\)This act also divided the colony of Canada into two provinces, Ontario and Quebec
The British North America Act’s guidance on the relationship between Ottawa and the provinces, and its subsequent interpretation, was inconsistent. The federal government was allowed to create uniform laws in all of the common law provinces, but this was subject to provinces adopting the law, essentially creating a provincial veto. The Act included clear enumerated powers for both Ottawa and the provinces, and the Judicial Committee stressed the principle that the central and provincial authorities were each supreme in their respective enumerated jurisdictions; however, the Act also included a provision, though rarely used, allowing for central authorities to “disallow” provincial laws even in areas clearly under provincial jurisdiction [80, p.14-17].

Ultimately, however, the Judicial Committee’s interpretations managed to push back against any centralizing inclinations caused by the provisions of the British North America Act. Both central and provincial authorities have clearly enumerated powers, and central authorities were given residual powers as well as powers over trade and commerce. In the U.S., this circumstance has led to significant expansion of central authority. However, the Judicial Committee, unlike the U.S. Supreme Court, interpreted trade and commerce powers narrowly, limiting their centralizing effect. Instead, they gave a wide interpretation to the enumerated provincial powers in property and civil rights, expanding provincial authority significantly and tilting the institutional balance of power between central and provincial governments toward the provinces. Even since the Supreme Court of Canada’s ascendancy to the actual court of final appeal in 1949, government powers have tended to expand, but the balance between central and provincial powers has not changed [80, p.17]. This has created a situation in which Ottawa has very little explicit ability to implement wide varieties of policies in the provinces.

Quebec, with a civil law system, was not covered under this provision.
In addition, the need for patriation of the Canadian constitution itself lent significant bargaining powers to the provinces. When Canada became officially independent in 1926, it became clear that having a constitution that was under the jurisdiction of the British Parliament, without any provisions for amendment within Canada, was unworkable. The Canadian constitution needed to be “patriated,” and Canada needed to agree on an entirely domestic procedure for amending the constitution to fully separate the Canadian constitution from British law.\textsuperscript{16} Thus began a process of negotiation and debate that lasted from 1926 until 1982 and which, in some senses, has never been fully settled.

From the beginning, the process of patriating the Canadian constitution was conceived of as an exercise in executive federalism: in 1927, the Prime Minister met with all of the provincial premiers to attempt to find an amending formula which would be acceptable to all, with little to no legislative oversight at either central or provincial levels. This attempt failed, as did three other attempts between 1927 and 1949. In 1949, Canada achieved partial patriation of the constitution, when a British statute allowed for amendment of the Canadian constitution by the Canadian Parliament in most areas. However some areas, including any amendments dealing with the rights and privileges of the provinces or with language policies remained under the authority of the British Parliament [80, p.30]. Ultimately, to fully resolve this issue, both the Prime Minister and the premiers assumed that all of the provincial premiers would have to agree unanimously, which gave the provinces significant bargaining power. In addition to regional disagreements regarding which provinces should be allowed to serve as veto points, the premiers demanded the ability to opt out of amendments dealing with provincial issues or property and civil rights, attempted to demand com-

\textsuperscript{16}The use of the word “patriate” is a uniquely Canadian invention indicating the fact that, as the British North America Act was never a domestic Canadian legal entity, the constitution could not be “repatriated.”
pensation for any income forgone by opting out, and also demanded the ability to selectively annul parts of the Charter of Rights in relation to specific laws through the use of the "notwithstanding clause."

After thirteen rounds of negotiation, driven by immovable provincial demands and, especially, the difficulty in appeasing both Quebec and the rest of the provinces, the Supreme Court of Canada issued a decision allowing that Ottawa needed only substantial, not unanimous, consent from the provinces to patriate the constitution. In 1982, Ottawa came to an agreement with nine of the provinces on a package that included a Charter of Rights (a centralizing force), but also the notwithstanding clause (which mitigated the centralizing effect) as well as the ability for provinces to opt out of amendments dealing with provincial jurisdiction (a strong decentralizing effect), but only providing compensation for opting out of amendments dealing with education or cultural affairs (mitigating the decentralizing effect). Quebec, with concerns about the amending formula (and their lack of a veto) as well as the Charter of Rights, refused to sign on to the agreement. While this arrangement did not give Ottawa the ability to create nationwide policies, as it clearly would have preferred, it did finally shift the bargaining leverage away from the provinces. Even Quebec, though dissenting from the constitutional agreement, lost significant bargaining power. The constitutional question had been effectively settled, and Ottawa’s stance was that it applied equally to all provinces, regardless of their express assent.

Overall, the institutional framework guiding intergovernmental relations in Canada has traditionally been tilted in favor of the provinces, with the powers enumerated in the constitution leading to a relatively expansive (and well-protected) jurisdiction for provincial governments. Furthermore, the extensive constitutional wrangling that occurred over decades further strengthened the provinces’ hands against Ottawa. The Charter of Rights, itself hobbled by the availability of the
notwithstanding clause, was the only strong nod to unification or centralization of policy. While the significant (though not entire) resolution of the constitutional issue in 1982 reduced provincial leverage going forward, there is little written into Canadian institutions that affords the central government any ability to dictate or oversee provincial policy. To accomplish that, Ottawa must creatively use ambiguities in the written institutions to exercise their influence.

3.6.2 Fiscal Relations and Policy Leverage

I argue that, limited by the institutional structures of intergovernmental relations, the Canadian central government uses money to achieve significant harmonization of policy across provinces. By substituting fiscal influence for more direct institutional power, important federal policy goals have been effected while provinces have maintained independent policy-making powers. To accomplish this, Ottawa has used three main fiscal strategies, each of which is allowed by the institutional structure, but none of which seems to have been envisioned by the institutions. The first are agreements regarding tax collection and sharing, leveraging federal administrative capacity to increase centralized revenue collections. Second, and most significant, is the federal spending power, the term Canadians use for the ability of the central government to spend money on areas of provincial jurisdiction. Last is the way in which Ottawa can induce desired provincial policy outcomes through limits on the institutionalized ability of provinces to opt out of federal policies and programs. This section will discuss the use of each of these strategies, and will especially focus on the negotiations around these strategies during the Meech Lake round of constitutional negotiations. The arguments made during these negotiations effectively illuminate a shared understanding of how the federal government uses these strategies, and how important they are to achieving central policy goals.
TAX COLLECTION AND TAX SHARING

The first strategy, centralized tax collection and sharing, was used extensively by Ottawa in the post-war period to allow for the creation of the Canadian welfare state, and helped to create the circumstances that generate some of Ottawa’s fiscal leverage. During World War II, there was concern that the federal government may not have the resources necessary to accomplish national goals, and the provinces agreed to “rent” to the central government their personal and corporate income taxes as well as succession duties [93, p.115]. Thus, Ottawa could bring in enhanced revenues without increasing the overall tax burden and, in exchange, offered unconditional grants to the provinces. Post-war, with many Canadians worried about future economic prospects and their implications for social welfare, the federal government proposed extending these wartime taxation arrangements, again in exchange for both unconditional grants and conditional grants in certain policy areas like health care [93, p.115]. While several provinces balked at the terms offered for this arrangement, with the promise of enhanced unconditional grants all but Quebec and Ontario signed on for a five-year renewal and, in 1952, Ontario also agreed to the arrangement [93, p.117]. By 1962, Ottawa did away with explicit tax-sharing agreements, largely because it was concerned about the lack of direct fiscal responsibility leading to excess provincial expenditures. Nevertheless, it continues to collect and distribute income and succession duties for all provinces except for Quebec (thus, among other things, maintaining tax harmonization) [93, p.118].

In addition, Ottawa used much of the revenue it gained from centralized tax collection for joint federal-provincial programs, generally in the areas of health and education—policy areas that are under provincial jurisdiction. In these centrally-led programs, the federal government provided the funds while the provinces adminis-
tered the program, subject to federal standards and conditions. Quebec continued to express its displeasure with centralizing policies, this time by refusing to participate in federal-provincial programs with federally-mandated conditions, but demanding compensation commensurate to what the other provinces received. Quebec brokered a deal with Ottawa on youth programs and student loan agreements, whereby the federal government reduced federal tax rates in Quebec, allowing Montreal to raise provincial taxes and increase provincial own-revenue without increasing the overall tax burden. For some programs, including for hospital insurance, Ottawa agreed to offer this deal to any province that requested it, though the provinces would still be required to meet federal conditions for the grant; only Quebec chose this route, and continues to do so [93, p.118]. As I will discuss below, Quebec’s actions here may seem to shed doubt on Ottawa’s success at inducing policy harmonization but I argue that they are the exception that proves the rule. For each of Canada’s other nine provinces, basic policy agreement is, usually, strong enough that explicit harmonization of a variety of policies and programs are high on the federal governments list of goals. For Quebec, on the other hand, Ottawa has consistently faced much stronger and more fundamental disagreement about policy and identity. In the case of Quebec, the ability to buy some level of loyalty and harmonization is a goal that precedes aligning policies on healthcare or education.

By at least the middle of the twentieth century, Ottawa had become adept at using tax collection and tax sharing policies to induce some level of policy convergence throughout the country, though in later years this approach would be overtaken by use of the federal spending power.
The Federal Spending Power

While tax sharing was a useful tool as Canada’s central government began to pursue a vision of national programming, including in health, education, and other social services, Ottawa eventually recognized that the extreme lack of fiscal autonomy also created substantial risk for the central government. By the 1970s, the central government turned away from tax sharing and toward the use of the federal spending power. In Canada, the term “federal spending power” is used to describe any circumstance under which the federal government spends federal money in areas of provincial jurisdiction. While this may seem so natural as to be unproblematic, the constitutional reasoning behind the federal spending power in Canada has been important in the development of intergovernmental relations in Canada and particularly in relations between Ottawa and Quebec. As noted above, the Canadian federal government does not have an expansively-interpreted commerce clause to justify a variety of social, education or infrastructure spending, and the sanctity of provincial policy jurisdiction has generally been upheld. Many of the areas in which Ottawa would hope to create harmonized national programming are entirely out of their reach. Given the relative leverage that the patriation process and Quebec’s complicated status have lent to the provinces, clear acknowledgement of this jurisdiction is jealously guarded. Where the central government has found space for influence is that, while the courts have consistently guarded areas of provincial policy jurisdiction from direct federal intervention, there is tacit agreement that the federal government has the ability to spend central money as it chooses. In areas of provincial jurisdiction the central government cannot force provinces to accept its money, or its policies, but it can offer them.
This is not without disagreement, most consistently from Quebec. While a 1940 federal commission on federal-provincial relations emphasized the idea of nationally designed programs with national standards, as early as 1956 Quebec’s own commission on constitutional issues questioned the constitutionality of this power, noting “what would be the good of a careful distribution of legislative powers, if one of the governments could get around it and to some extent, annul it by its taxation methods and its fashion of spending?” [111, p.95]. This was never adjudicated in the courts, and in the early years these specific objections were accommodated through particular opting-out arrangements, including those mentioned above as well as the central government’s agreement to allow for a specifically Quebecois pension plan alongside the Canada Pension Plan. The fundamental disagreement, however, remained.

Throughout the patriation process, negotiations included issues related to the federal spending power and opting out, with a variety of proposals and counter-proposals on the types of amendments from which provinces would be able to opt-out and which of these opt-outs would come with fiscal compensation—and in this case, while Quebec was the most strident in its demands, other provinces also had requirements regarding provincial opt-outs. In the final version of the 1982 Constitution Act, provinces have the option to opt out of any amendment that transfers provincial powers to the federal government, as they had demanded. For most amendments, the province that opted out would get no monetary compensation from the federal government; if they want the additional funding for healthcare or pensions, they must participate in the federal program. However, the amending formula resulting from the patriation debates did allow for reasonable compensation in the case of amendments that relate to education or other cultural matters (representing approximately the amount that “the federal government would have spent in the province had it not opted out of the national scheme” [80, p.74]). At the time, Prime Minister Trudeau was reasonably clear that,
despite the preferences of the provinces, he had no interest in institutionalizing the requirement of compensation for opting out of all amendments, because he wanted to maintain increased funding as an inducement for participation in federal programs. With compensation, provinces would face no penalty for opting out of federal programs so the federal government would have no leverage.\footnote{Of course, this does not preclude the central government from offering compensation for opt-outs in other areas, as it has done with Quebec, but this would be a political process rather than a constitutional issue.} Provinces accepted this in exchange for the inclusion of the notwithstanding clause. The agreement to compensation in cultural and educational issues was an explicit recognition of Quebec’s concerns, which was important given Quebec’s fundamental objections to the 1982 Constitution Act [80, p.75].

**Meech Lake**

Since the 1982 patriation of the constitution, Ottawa has attempted several times to “bring Quebec in” to the constitution, by negotiating and passing a set of amendments that would allow Quebec to give explicit consent to the constitutional regime under which they live. Because of the conviction that a new constitutional agreement would have to be unanimous, this has been a torturous and often quixotic project. The most extensive and nearly successful attempt was the negotiation and near-ratification of the Meech Lake Accords, a process spanning 1985-1990 and encompassing the full variety of provincial-federal constitutional questions. While the Meech Lake accords eventually failed at the ratification stage in 1990, the process of gaining the provincial premiers’ agreement to the accords in 1987, as well as the political arguments that followed, provided significant insight into the arguments at stake regarding intergovernmental relations in Canada. The federal spending power, the ability (or lack thereof) of the federal government to enforce conditions or standards on programs, and the
question of opting out (again) all featured prominently in these debates. While these issues shared the stage with—and occasionally acted as negotiating pawns for—other issues, particularly the amending formula and the introduction of a clause recognizing Quebec as a distinct society within Canada, this overview of the Meech Lake negotiations will focus almost exclusively on the issues and arguments surrounding federal spending and federal policy influence.

When Brian Mulroney became Canada’s prime minister in 1984, he used his background as a fully bilingual Quebecker, as well as the Progressive Conservative’s general preference for less centrist arrangements, to bring Quebec on board his coalition, despite their history of being hostile to the Progressive Conservative party. It was clear that he intended to negotiate a grand deal to reintegrate Quebec, and he transparently signaled openness on several of Quebec’s traditional demands, including the federal spending power [108, p.42]. He almost immediately began bilateral negotiations between federal representatives and provincial leaders, searching for areas of agreement and assessing the possibility of a deal. He attempted to structure the negotiations such that the federal government served as a broker between Quebec and the other provinces, an approach that both gave the federal government the appearance of neutrality and placed it firmly in charge [108, p.52]. This culminated in a meeting of the provincial premiers at Meech Lake in April 1987, and an agreement which was then debated and eventually rejected over the next several years.

As one of Quebec’s consistent sticking points, the federal spending power came up early in these discussions. During the pre-negotiation period in 1985, a Quebeccois minister described the federal spending power as a “sword of Damocles hanging menacingly over all planned policies of social, cultural or economic development” and proposed that all such programs and expenditures must be subject to provincial approval [108, p.56]. By 1986, this objection had clarified itself into a demand that
federal spending on all areas of exclusive provincial jurisdiction (even direct payments to individuals) should be limited, and that not only should any shared cost program be subject to provincial approval but any province that chose not to participate should be entitled to fair compensation for the funds that they would be missing out on. Significantly, Quebec’s starting position was that not only should provinces be entitled to fair compensation, but there should be no obligation to use that compensation in the same policy area as the shared cost program from which they were opting. If Quebec were to gain money for opting out of a new childcare program, they should be free to spend that revenue on roads or agricultural subsidies instead [108, p.69]. On the other side of this argument were the federal government, which was unwilling to tie its hands that radically, and several of the smaller provinces, which were afraid that these limitations would discourage the federal government from creating new shared cost programs and would starve them of resources [108, p.76]. Even Mulroney, despite his general preferences for decentralization, noted how important it was “not to hobble the ability of the federal government to pursue positive economic and social measures” [108, p.85].

By the in-person negotiations at Meech Lake, a general agreement had been reached in several areas: first, only shared cost programs were on the table, not direct federal spending; second, compensation for opting out of any amendments affecting provincial powers could be required (recall that under the 1982 constitution only opt-outs of amendments in education or cultural areas required compensation); and, last, that opting out of shared cost programs (separate from constitutional amendments) in areas of education or other cultural institutions should also be subject to reasonable compensation. Still at issue, however, were shared cost programs in areas other than education or cultural institutions, as well as the expectations that could be required of the provinces to qualify for compensation [108, p.87]. At the Meech Lake meeting
itself, Manitoba and Newfoundland in particular took issue with requirements that a certain percentage of provinces agree before Ottawa could introduce new federal shared cost programs, while Quebec took issue with a proposal that provinces should be required to establish alternative programs consistent with “national standards" to receive compensation when opting out of a shared cost program [108, pp.96-97]. Under the final compromise, the federal government retained the ability to introduce shared cost programs without provincial consent, while the requirements for obtaining compensation for opting out of such a program were granted increased flexibility such that provinces would be entitled to compensation if they introduced “an initiative or program that is compatible with national objectives" rather than needing to conform to national standards [108, p.97].

After the final accords accepted by the Prime Minister and the provincial premiers at Meech Lake were made public, the contentious politics behind the federal spending power became even clearer. When some critics expressed concerns that the accords weakened Ottawa’s powers, the Ontario attorney general, a consistent ally of Mulroney in these negotiations, argued that the agreement increased federal powers by formally recognizing the federal spending power. While this appeased that set of critics, it alarmed those who were concerned about expansive federal interference in areas of provincial jurisdiction, particularly the Quebecois who had consistently questioned the basic constitutionality of the federal spending power. In response, Quebecois leaders argued that the requirement of meeting “federal objectives" was so flexible as to be almost meaningless. The example Quebecois leadership gave was of a federal shared cost program to build sidewalks, from which, in their account, Quebec could opt out, receive compensation, and use that compensation to build, for example, a bridge [108, p.105]. It became clear that the agreement reached at Meech Lake was either extremely fragile or illusory. This disagreement caused Manitoba and Ontario
to re-open discussion about the requirements of “national standards” as opposed to “national objectives” to clarify provincial responsibilities when opting out of shared cost programs. Quebec insisted that this was reneging on the agreement that had already been made, and was joined by British Columbia and Alberta in expressing concerns about federal overreach [108, p.122].

Ultimately, the premiers arrived at a compromise involving a small wording change (the addition of “the” in front of “national objectives”), and the Meech Lake Accords failed in ratification not primarily because of disagreement over the federal spending power but because of the uneasy balance of power between Quebec and English-speaking Canada and an amending formula that makes change extraordinarily difficult. The strong arguments about the federal spending power that were made in the process of negotiating the Meech Lake Accords, however, demonstrate competing impulses in the relationship of provinces to federal expenditures: on the one hand, the provinces recognize the extent to which federal expenditures serve as an important and sometimes irreplaceable resource for provincial programming, while on the other hand giving the federal government extensive influence in policy areas from which they would otherwise be entirely excluded.

POST-MEECH LAKE

The failure of the Meech Lake accords did not end discussion over the federal spending power and opting out, though it did form the most extensive discussion and came closer to finalizing an agreement on the matter than any subsequent attempt. The Charlottetown Accords, an unsuccessful follow-up which primarily attempted to remedy some of the process errors which doomed ratification of Meech Lake, stuck with Meech Lake’s agreement on compensation and opting-out without re-litigating the matter. With no successful amendments to the status quo however, and even
given the relatively quiet status of Quebec since the 1995 secession referendum, Quebec has continued to reject the legitimacy of the federal spending power, while the other provinces have negotiated agreements with Ottawa on the same. In 1999, all provinces except Quebec signed on to the non-binding Social Union Framework Agreement, which recognized the federal spending power as legitimate while introducing an agreement that new shared cost programs would require consent from a majority of provinces and that excess funding caused by existing provincial programs in the relevant policy area could be reinvested in the same or a related policy area, rather than returned to Ottawa [93, p. 123]. Despite these modifications, Quebec not only refused to sign on to the Social Union Framework Agreement but expressed its continuing displeasure in 2002 by issuing a report that proposed “the abolition of existing social transfers, which were to be replaced by a new division of financial resources giving more revenues to the provinces," and went on to question the legitimacy of the federal spending power as “a means of intervention...whose constitutionality has not been established" [93, pp. 103-104]. The federal government clearly expressed its disagreement with this opinion, though under Harper’s government the use of the federal spending power was reduced enough to quell some of Quebec’s concerns. It should be noted, however, that even after Harper’s relatively modest use of the federal spending power, the revenue gap between federal and provincial governments has remained large enough to maintain significant federal influence in the provinces [93, p. 104].

3.6.3 Implications and Discussion

It is clear that the fiscal strategies that the Canadian federal government uses to influence provincial policy and the extensive disagreements over these strategies have had a strong effect on intergovernmental relations in Canada, but they also relate
clearly and specifically to my claims above, including: first, that central governments use federal spending to influence subnational policymaking; second, that this spending has induced some measure of policy convergence; and, last, that the price of policy, whether in terms of the extent of policy preference divergence or the opportunity cost of the funds, will affect the extent to which central governments buy policy from subnational units. Put simply, Ottawa has consistently and transparently pursued access to strategies that allow it to spend federal money in the provinces in pursuit of central policy goals. At first the central government used preferential access to tax revenues to establish a place for the federal government in creating programs and policies in the provinces, in areas of provincial jurisdiction. In a refinement of that strategy, the federal government then turned to shared cost programs and general use of the federal spending power to pursue central policy priorities throughout the provinces.

HYPOTHESIS 1: PREFERENCE CONGRUENCE AND TRANSFERS

Ottawa’s fondness for shared cost programs and the federal spending power is obvious throughout the intergovernmental negotiations described here. Particularly, its reluctance to expand compensation for opting out of shared cost programs makes clear that Ottawa relies on these federal spending powers to influence provincial policy. This explanation for central expenditures in and to the provinces makes the implications of the quantitative analysis above clearer. Ottawa uses an extensive network of transfers and shared cost programs to implement national policies and programs, and all provinces benefit fiscally from this arrangement. Provinces get revenue to pursue programs and policy goals, while the center gets oversight and input. It is unremarkable, however, that some provinces at some times wish to pursue the policies preferred by the federal government and simply require sufficient funds and support to do so,
while others would prefer to pursue different policies or to pursue them in a different manner. Based on the analysis above, it appears that, when subnational units are more reluctant to accede to Ottawa’s preferences they may require an extra monetary push to bring them on board—all provinces benefit from this arrangement, but they do not do so equally.

The record of negotiations and statements on the federal spending power, shared cost programs and opting out demonstrate the center’s purposes in pursuing these strategies—federal spending in the provinces is meant to act as leverage to encourage provinces to implement centrally-preferred policies. While the differential nature of these expenditures based on policy congruence or lack of congruence is less clearly documented, combining the statistical analysis with the historical record makes a clear argument: Ottawa uses marginal increases in funding to buy policy influence from premiers who, because of different political and policy affinities, are more reluctant to agree to central policies.

HYPOTHESIS 2: POLICY CONVERGENCE

The Canadian case also provides evidence that this sort of strategic use of intergovernmental transfers can effectively induce some measure of policy convergence. The arguments about the federal spending power at Meech Lake suggest that both the federal government and the provinces recognize the extent to which federal spending on areas of provincial jurisdiction is an important tool for influencing provincial policy and increasing policy congruence. During this process, smaller provinces acknowledged their dependence on this revenue source, while indicating their acceptance of the policy implications of this interference. Most larger provinces, on the other hand, while wary of significant restrictions on these expenditures, expressed concerns about
federal policy interference, acknowledging the influence of these strategies. The central government expressed willingness to negotiate the details, but admitted their unwillingness to completely give up such a powerful policy tool. And Quebec, the most distrustful and distant of the provinces, has expressed a preference for tying their own hands by ending both the policy interference and the associated revenues. In the discussions on opting out, it becomes even clearer that Ottawa intends these shared cost programs not only as a way of using central money to extend social services throughout the provinces, but depends on them to influence the particulars of the policy being pursued and how it is implemented. While the provinces preferred arrangements that broadened provincial policy autonomy in the areas of shared cost programs (unless they significantly feared that a drop in revenue would accompany this autonomy), the negotiations made it amply clear that the central government required some say over policy priorities and objectives to continue these expenditures.

Ultimately, much of Canada’s policymaking in healthcare, pensions and social services, and even education are dominated by shared cost arrangements that introduce significant policy influence for the central government. And the backbone of Canada’s social welfare state, which together looks strikingly like a fully formed national policy, is constitutionally under sole provincial jurisdiction; it was built by the federal government, through the provinces, using these funding arrangements. Canada’s unemployment, education, housing, social assistance, and even its universal healthcare program are all provincial-level programs rather than nationally-administered social welfare programs. Though these are co-funded and overseen by the federal government, this

\[18\] Of course, Quebec’s preference is clearly for continuing or expanding these revenues while ending the associated interference, but their arguments for ending the federal spending power entirely suggest that their second best solution is an end to the revenues, if that is necessary for ending the policy interference.
central influence has been achieved not through the introduction of Canada-wide programs but through the steady expansion and refinement of the federal use of shared cost programs to encourage provincial compliance. The hypothesis that policy convergence will increase with increased use of intergovernmental transfers cross-nationally is beyond the scope of this paper, and well worth further study. The Canadian case, however, does suggest that increased use of intergovernmental transfers across time, particularly when approached strategically, are associated with more consistent and consistently implemented policies across provinces.

Hypothesis 3: Price of Policy

Last, there are two ways in which the Canadian case touches on the hypothesis that a higher price for policy reduces the effectiveness of intergovernmental transfers for policy convergence or reduces the extent to which central governments are willing to expend the resources necessary to induce policy convergence. First, as mentioned above, while Quebec looks at first glance like a failure in the center’s attempts to produce its preferred policies, in is better understood as an example of a context in which the price of policy is unusually high. While Quebec may have some of the same quotidian policy disagreements with central leaders that characterize relationships with the other provinces, there are more fundamental issues at stake in Ottawa’s relationship with Montreal. As indicated by the Quebec separatist movement (resulting in two secession referenda) as well as the extreme difficulties in coming to an agreement over several constitutional issues, the basic status of Quebec within Canada’s federation has yet to be settled definitively. Prior to questions about how healthcare payments should be structured or what education standards must be met, which is often the level at which other provinces are operating, Quebec still poses (and, espe-
cially through the closing decades of the twentieth century, posed) basic questions about language, immigration, and constitutionally protected rights.

In other words, for Ottawa, buying policy from Quebec is very, very expensive. This is not to say that Ottawa does not engage in buying policy from Quebec. Quebec does generally receive higher per-capita transfers than other provinces, though the statistical significance of this effect varies. More than that, however, Quebec also receives different types of remuneration than other provinces: relying more on tax abatements than direct transfers; negotiating compensation for opting out of federal programs, even in areas where that is not required [93, p.108]; and, on occasion, even bringing in government contracts under potentially politicized circumstances [108, p.64]. That these arrangements come with fewer strings and less policy influence than policy-buying schemes with other provinces does not mean that Ottawa is failing to buy policy from Quebec. Instead, central leaders are using the money and influence they spend in Quebec to convince Quebecois leaders to be less resistant on basic markers of Canadian unity and leaving aside many (though not all) specific policy issues as beyond their budget. In other words, though Ottawa still engages in buying policy in Quebec, the high price of this policy means that actual policy convergence is more limited than in the rest of the country.

Relatedly, an overview of fiscal relations in Canada over time suggests the importance of resource availability for the federal government’s ability to buy provincial policy. In times of resource scarcity, these approaches can be unilaterally scaled back by central governments that suddenly find the ability to pay central obligations or project a central surplus more important than buying subnational policy. For example, between 1994 and 1998, Ottawa reduced the amount of cash social transfers to the provinces by 33%, despite subnational protest [93, p.103]. Given unilateral action on Ottawa’s part, provinces became more autonomous and policy priorities like health-
care were often executed more independently at the provincial level, without as much central oversight. In the late 1990s, however, when resources became more abundant the negotiations shifted once more to the national and intergovernmental stages [93, pp.126-127]. In this case, it is opportunity costs that are driving the high price of policy, rather than the extent or importance of policy differences, but the result is the same. When policy change, bought and paid for by intergovernmental transfers, is in the federal government’s budget policy convergence is likely to occur. When it is not, the extent of policy convergence will be limited or non-existent.

In general, the Canadian case provides abundantly available data, both quantitative and qualitative, to explore the role of central spending in influencing subnational policy. The quantitative analysis provides evidence that central spending in the provinces is driven, at least partially, by an impulse to bring dissenters on board with central policy preferences, rather than a strong commitment to equality or a desire to reward existing supporters. The extensive discussion and development of Canada’s approaches to intergovernmental fiscal relations demonstrate clearly the center’s desire to influence subnational policy, even when there are no clearly delineated institutional means for doing so, as well as how important federal spending in the provinces has been in achieving this goal. Many of Canada’s nationally unified and integrated policies have come not from a broad national consensus on policy priorities or from strong central powers in the social arena (indeed, Ottawa faces very limited explicit powers here), but from a highly political process of using grants and shared cost programs as inducements to ensure comprehensive implementation of Ottawa’s preferred policies.
3.7 Conclusion

What does this tell us about intergovernmental relations more generally, and about how central governments distribute intergovernmental transfers and use them to accomplish their own goals? As previous studies have suggested, central governments are concerned with electoral outcomes and they may, in some cases, distribute intergovernmental grants to affect these outcomes, though there is little clear evidence of this in the Canadian case. Certainly, central governments may also be concerned with the effectiveness of policy implementation—Ottawa’s consistent willingness to work with provincial governments to achieve shared policy goals, and to allocate resources to these goals, suggests that this is a motivating factor in this case, and it is unremarkable to assume that it is a factor in many other cases. However, as I suggest here, and which seems to be a significant factor in decision-making in the Canadian case, is that central governments are also concerned with policy outcomes, and particularly with getting their preferred policies implemented throughout the country they govern. This interest may be primarily based on genuine ideologically-based policy preferences or on seeking to accomplish the policy goals of their coalition and supporters for electoral purposes, but in either case policy outcomes matter. And when central tools for influencing subnational policy are limited, I argue that central governments use money to close that gap.

The model presented here, based on existing spatial models of policy preferences, demonstrates formally how central governments might use transfers to influence subnational policies in areas that are outside of central control; it also suggests that this dynamic may be useful even in cases where the central government can choose to keep policy control, though under more limited circumstances. While the Canadian case does not provide leverage for testing this part of the theory, exploring empirically
when and how more centralized governments use intergovernmental transfers rather than centralized administration to effect policy suggests an opportunity for further research. In more formally decentralized cases, where central governments would find significant difficulties creating centrally administered programs even if they wanted to, the theory and model presented here suggest that central governments will try to provide central funds in exchange for certain policy outcomes, that these funds will be distributed more heavily to subnational governments with preferences that are more dissimilar to the center’s, and that this will be more likely and more effective when the price of policy is lower.

Based on both the qualitative and quantitative evidence, many of these dynamics seem to be at work in the Canadian case. The central government is consistently and transparently concerned with specific types of policy outcomes in the provinces, and is explicitly willing to use central funds to encourage provinces to achieve these outcomes, despite frequent subnational disagreement. Provinces with subnational leaders that disagree with the central government on a variety of policy outcomes get more money from central coffers than do those that agree, across time and across space. And the central government is more likely to engage in this effort when funds are plentiful, when the policy is particularly valuable to the center, and policy goals are achievable. In short, the central government cares not just about effectiveness, not just about electoral outcomes, but about policy in the provinces, and they regularly use central funds to pursue their goals in this area. Anecdotal evidence from other states and other policy areas, from Chechen secessionism in Russia to the drinking age or Medicaid expansion in the United States, suggests that central governments regularly use central funds to influence subnational policies. The exploration of Canadian intergovernmental relations provided here lends support to the argument that central governments use intergovernmental fiscal relations as a policy tool.
Major questions remain in exploring how widely this dynamic operates, and how it may fit with previously documented features of intergovernmental fiscal relations, including when central leaders are likely to use money for policy and when electoral outcomes are more likely to drive transfers. Does the existing level of decentralization drive this effect? Do the particular electoral institutions or coalitional dynamics under which the government operates determine how it chooses to distribute transfers? And, are there additional tools other than the distribution of central funds that central governments use to influence subnational policy? It seems clear, however, that future work should consider the central government’s interest in explicitly asserting influence over subnational policy outcomes. Intergovernmental relations are not simply an institutional framework or even an arena for negotiation, but are also a tool that central governments use to achieve their goals, politically, fiscally and, yes, in policy.
3.8 Figures: Buying Policies

Figure 3.1: Order of decision-making under model form 1

Figure 3.2: Policy space and ideal points

Figure 3.3: Inclusion of policy limit, $\lambda$

Figure 3.4: Inclusion of randomly-drawn state of the world, $\omega$
Figure 3.5: Order of decision-making under model form 2

- C decides whether to delegate and to set policy limit (\( \lambda \))
- Policy (\( p^* \)) is chosen
- State of the world (\( \omega \)) and so outcome (\( x \)) is revealed
- S decides whether to retain agent
Chapter 4

Decentralization and Increased Debt: Strategy not Accident

4.1 Introduction

Even as central governments expend resources on intergovernmental transfers to influence subnational policy, they also face the task of marshalling sufficient resources to govern. Developed states with large tax bases and steady access to credit often manage this without much question, and with resources to spare for developing effective control mechanisms or influencing subnational decisions. For a significant proportion of states, however, simply finding resources to provide the services and rents necessary to remain in power is a daunting task. The last specific tool of intergovernmental relations that this dissertation deals with is subnational budgets and debts, which central governments use to expand overall government expenditures and reduce budget pressures in the short term. This chapter argues that subnational budgets and overspending can create soft budget constraints for central leaders, allowing them to encourage subnational overspending to increase government expenditures without increasing central deficits or debts. While this approach poses problems for the long term, the intertwined nature of central and subnational budgets and spending provides an important short-term tool for central governments that wish to expand government spending and services without threatening electoral prospects or borrowing opportunities. This chapter explores how central governments use subnational budgets as extensions of central budgets and argues that this strategy is behind the
large subnational deficits and unsustainable debt loads that previous research has identified.

4.1.1 Central Budgets and Subnational Debt

Subnational debts are far from small change: in 2001, for example, Argentina’s provincial debt reached 100 percent of consolidated provincial revenue at $29.4 billion, while at the same time Brazil restructured approximately $100 billion in subnational debt [57, p.225; 273]; most dramatically, as of 2015 China was offering a debt swap for portions of an estimated $3.55 trillion in local government debt [145]. When subnational governments borrow money this significant, unregulated or under-regulated by central governments, it has historically led to crisis and financial havoc. Understanding why subnational governments overspend and cause fiscal crisis is fundamental to effectively curbing the issue and promoting fiscal stability. Standard explanations for subnational overspending attribute the problem to soft budget constraints and a lack of credible anti-bailout commitments by central governments. I suggest instead that some central governments encourage subnational borrowing as a means of moving central expenditures off-books. If this is the case, the commonly suggested institutional fixes will be ineffective at reducing subnational borrowing, which must instead be understood as a symptom of larger fiscal issues and pressures for government borrowing.

On average, decentralized and federal states spend more than centralized and unitary states [127, 129]. They carry higher overall debt burdens and some have faced ballooning subnational debt burdens and defaults that have threatened the overall fiscal stability of the state [65, 129]. Existing explanations attribute this tendency to particular configurations of center-periphery relations that encourage subnational units to pursue unsustainable deficits and debt burdens. They continue to borrow more, on the assumption that these debts are implicitly underwritten by the center,
and this assumption and the underlying institutional arrangements make it difficult for states to deny bailout requests in the case of eventual subnational fiscal crisis [129]. While some states have instituted limits on subnational spending and debt loads either in response to crisis or preemptively, the strength and effectiveness of these limits vary and many continue to face accumulation of subnational debt for which they may someday become responsible.

Given the risks, why do central governments continue to allow provinces and states to spend freely and accumulate debt for which the center may one day be held responsible? Some explanations suggest that path dependence and institutional inertia keep states from instituting provincial-level borrowing limits and balanced-budget requirements [129]. While this logic may be at work in specific cases, other states actively provide access to financing for subnational units [57] and the trend has actually been toward expanded subnational access to debt, particularly in emerging and middle-income economies [27]. Is there, instead, a possible strategic and intentional explanation for central inaction, even in cases where precarious fiscal stability may be strained or ruined entirely by subnational extravagance? I argue that central governments, rather than being at the mercy of accidental institutional forces, use subnational expenditures and subnational debt as a means to increase total government expenditures without increasing central fiscal imbalance.

At first glance, it seems self-defeating and counterintuitive for states to encourage disastrous debt levels. For governments that face short time horizons, however, it may be perfectly rational. For many states, including but not limited to less developed states, the social and service expenditures necessary to forestall unrest and revolt (in the streets or at the ballot box) are simply unsustainable. Even when the resources are available, many central governments find it politically necessary or expedient to prioritize security expenditures, national-level patronage projects, and other line items
over spending central money on services. On the other hand, meeting basic expectations for these services can be imperative for maintaining broader regime support. Central governments may, of course, rely on increasing central debt levels, but these figures are scrutinized by the public, ratings agencies, and international organizations alike. One strategy for resolving this conundrum is to decentralize service provision responsibilities while reallocating only a fraction of the necessary resources. Decentralization policies at least partially absolve the central government of responsibility and obligate subnational expenditures, regardless of the funds that accompany the responsibility. In this case, the center fully expects that subnational units will overspend and accrue debts—in fact, it has made it nearly impossible to do otherwise—but central debt levels will remain static while services will continue or improve. For governments facing significant shortfalls and short time horizons, this theory explains both the relationship between decentralization and overspending and why central governments would allow this relationship to persist.

I argue and provide evidence that, in some cases, subnational deficits are the result of strategic central choices rather than the unintended effect of institutional structure. Under some circumstances, central governments gain from shifting deficit spending away from central budgets and into subnational budgets, which are both more obscure and more diffuse. Like Enron shifting bad debt off-budget into special purpose entities and other subsidiaries, this allows governments to proceed as usual, theoretically indefinitely, while continually running unsustainable and non-productive deficits. If this is the case, it has several important implications: first, this suggests that institutional fixes, often prescribed by current explanations, are unlikely to seriously limit subnational debt; second, it emphasizes that central and subnational fiscal balance cannot and should not be understood independently, given that central governments implicitly use subnational budgets as extensions of their own budget; third, if central
and subnational leaders are intertwined in this way, it introduces fruitful questions as to the overall political and economic relationship between center and periphery.

In the following sections I will first introduce the explanations and assumptions underlying existing accounts of subnational fiscal imbalance, in particular their reliance on the unintended consequences of the soft budget constraint. I will then present an argument that subnational debts are, in some cases, not unintended institutional consequences but instead the result of a central strategy that prizes expenditures on services and rents (and their resulting political stability) over fiscal stability. These central leaders will find subnational budgets to be a convenient tool for hiding fiscal imbalance without adjusting spending priorities. Following that, I will present my empirical approach and hypotheses, introduce my data, and provide results for my cross-national quantitative analysis. I will then discuss the implications of these results.

4.2 Standard Explanation: Subnational Debt as Accident

Existing explanations for subnational deficit spending attribute the issue to soft budget constraints, created by incredible central commitments that provide perverse incentives to subnational units to overspend. While this is a more sophisticated understanding of the consequences of decentralization than earlier “all good things go together” approaches, it still fails to account for more general incentives faced by central leaders. Because of this, standard approaches miss the strategic opportunities that decentralization and federalism pose for central as well as subnational leaders. In this section, I will briefly review the way in which the second-generation fiscal federalism literature provided a corrective for earlier approaches. I then continue by describing the weaknesses that this approach retains both in taking existing institu-
tions as given and in accounting for only the strategic incentives that subnational leaders face, not those driving central decisions.

For decades, early federalism literature focused almost exclusively on the myriad advantages of decentralization and federalism: it is more efficient [112], provides better services [146], makes better use of local knowledge [71], and is more democratic [100]. Federalism and decentralized arrangements have been encouraged as a means to manage ethnic cleavages and reduce corruption [12, 56, 73]. At the same time, however, some scholars began to be concerned about the possible negative effects of fiscal decentralization. The second generation fiscal federalism literature considers not just idealized system design but also the complex and often perverse incentives that actual policymakers face.¹ Treisman [151] suggested that decentralization could lock in tendencies toward high inflation, while Wibbels [162] more directly indicated that the institution of federalism may cause worse overall macroeconomic outcomes, as subnational units avoid the negative effects of fiscal adjustment by subverting central adjustment attempts. Scholars of American politics, including Berry [20], have observed that in areas where there are territorially overlapping governments, as in decentralized and federal systems, governments may see the available tax revenues as a common pool, leaving citizens at risk of overtaxation by the various jurisdictions (see also Oates [113], Stein [141], and Rodden [127] for additional discussions of federalism and government size).

These concerns about unintended consequences have included a number of appre-
hensive treatments, spanning policy, economics and political science, of the ways in which decentralization and federalism cause high and increasing debt levels [41, 65, 127, 129, 162, 164]. What these explanations have in common is the application of the

¹See Weingast [160] for an overview of the second generation fiscal federalism literature and Wibbels [163] for a discussion of its treatment in comparative federalism studies.
concept of the “soft budget constraint” in addressing the reasons for subnational overspending.² I will focus on Rodden’s work [127, 129] as the most developed example of this approach. The soft budget constraint approach explains subnational debts as the logical (though, by central leaders, unintended) response of subnational governments to the possibility of central bailouts [127, 129]. Because local governments face this soft budget constraint—that is, the center cannot commit to not bailing them out—the clear incentive is for local governments to overspend [129, p.50]. For Rodden [129], this characterization is most accurate where subnational governments are fiscally dependent on the center but also have significant borrowing autonomy. Rodden [129, p.96] argues that this combination is most likely in federations, where the institutional structure limits the center’s ability to restrict subnational borrowing. In this understanding, subnational debts are fundamentally an accident of institutional design. This theory is supported using statistical tests that show that federal states are more likely to have higher levels of borrowing autonomy, and that high levels of borrowing autonomy and fiscal dependence together are associated with higher deficits [129, pp.103-116]. Through the remainder of this chapter, I will refer to this approach as the “institutional explanation” because it relies on institutional design to explain subnational spending outcomes.

While the second generation fiscal federalism literature, including the institutional explanation, has moved away from an idealized institutional design perspective and toward examining actual effects of complex incentives produced by these institutions, it continues to explain the negative effects of decentralization, and particularly increases in subnational debt, entirely as unintended outcomes—when negative effects occur, the original purpose of decentralization has been subverted. What is missing is

²See Kornai [90] on soft budget constraints; the concept was originally imported from explanations for poor fiscal management of state-owned enterprises in transition economies.
a careful examination of the extent to which decentralization and the control of federal institutions have been used strategically by both central and subnational actors. While the possibility of central offloading of expenditures (including unfunded mandates) has been mentioned occasionally (see, for example, Garrett [61] and Wibbels Wibbels [163, p.176]), this possibility has not been seriously considered either theoretically or empirically, particularly in the comparative literature. Each of these approaches takes the existing forms or institutions of decentralization as given without considering the ways in which central leaders can initially, and even on an ongoing basis, affect these configurations. This leads to a narrow understanding of the strategic incentives and options that central leaders face.

This relative lack of attention to central strategic calculations can lead to unfounded assumptions, including that central governments will flatly prefer smaller debt levels and prefer for debt to be centralized. A reasonable reading of the institutional explanation, in which fiscally responsible central governments are hampered by reckless subnational governments, suggests that it assumes that central governments have a basic preference for balanced or nearly balanced budgets. This assumption is belied by worldwide tendencies for central governments themselves to run significant deficits, often despite full knowledge that these deficits and the corresponding mounting debt levels may be unsustainable. In a more generous reading of the institutional explanation it implies that central governments prefer for any debts to be accrued at a central level, where the center can control both the amount of debt and the types of expenditures for which it is incurred. This suggests that subnational budgets should be essentially balanced, while central governments run, ideally, a politically and economically manageable deficit. In this situation, total expenditures would be kept in check by central oversight.
I will note here that this attitude, and the institutional explanation itself, are almost certainly accurate in some cases. Where central governments have access to revenues or financing that is broadly sufficient for their needs and where leaders have reasonably long time horizons—in fact, in many of the cases that Rodden [129] engages qualitatively—the negative effects of subnational overspending likely outweigh the advantages of increased overall spending capacity. In these cases, the institutional configuration of high borrowing autonomy and fiscal dependence that is associated with ballooning subnational debt may well be the result of path dependence and institutional inertia [129]. I argue, however, that there is an alternative explanation for this institutional configuration (and its resulting subnational debts) which Rodden’s theory and empirics have not sufficiently accounted for. In cases where central resources are insufficient and time horizons are short central governments choose high borrowing autonomy and fiscal dependence precisely because it allows subnational overspending. In these cases, subnational overspending is not an unintended consequence of exogenous institutions but a direct consequence of central decision-making.

Specifically, the institutional explanation is likely to fail in cases where the politically necessary or policy-effective level of deficit spending is not politically or economically manageable. Government leaders, many of whom have a keen sense of political survival, rely on government spending, either on public goods or on private rents, to ensure continuation in office [59, 167]. Even if central leaders would prefer fiscal prudence, long-term sustainability is irrelevant to leaders who are facing short-term survival pressures. The puzzle leaders face in this case is how to spend enough to placate supporters and voters without running deficits that induce backlash from voters or international lenders. In these cases, the institutional explanation sheds little light on how governments balance these competing imperatives.
When central governments see the need for more spending than balanced budgets plus manageable central deficits will get them, they face two choices: to take on higher central deficits and higher levels of central debt or to encourage subnational units to take on higher deficits through some combination of changes in transfer levels, subnational service delivery expectations, and implicit bailout guarantees. There are clear advantages to the second strategy: while both are ultimately fiscally unsustainable, the first will be noted immediately by taxpayers, debt rating agencies, and international organizations and funders. Central governments wary of increasing central debts may, quite reasonably, wish to hide these debts and deny responsibility for them however they can.

Under Rodden’s model of the dynamics of subnational debt, central governments that are perceived as uncommitted face increasing and unwanted subnational debts, while those that can present themselves as being committed to avoiding subnational bailouts effectively induce subnational fiscal discipline. I suggest that some central governments that could credibly commit if they wanted to intentionally present themselves as being uncommitted. In this circumstance it is not a case of incomplete information, where central leaders cannot effectively commit to refusing bailouts. Instead, central and subnational leaders are both working with complete information—information that commits the center to bailing out subnational units and encourages overspending. Under this framework, it is not a game of credible commitments at all; instead, it is a simple case of all players correctly following established incentives.
4.3 Subnational Debt as a Strategy: the Enron Plan

Rather than subnational debts being the unintentional result of a combination of subnational fiscal dependence and borrowing autonomy, I suggest that this combination is created to allow for subnational debts. In other words, under some conditions subnational governments do not overspend in spite of central governments but because of them. I re-examine the existing empirical results linking decentralization and subnational debt in light of this proposition, and present evidence that in many cases it is strategic central decisions that drive increases in subnational debt, rather than independent subnational decisions. The same pattern of ballooning subnational debt and occasional bailout explained by the institutional explanation presented above takes on a different meaning if the center deliberately chooses to allow access to debt markets and never tries to commit to not provide bailouts, or never intends that commitment to be taken seriously. In this case, subnational units are not selfishly responding to incentives but following implicit expectations from the center; and the center is not faced with unintended debts over which they have no control but instead with the results of a deliberate, if perhaps short-sighted, policy.

While this policy may be short-sighted, I argue that there are significant reasons that it may also be appealing to some central governments. If a central government can increase total government spending (which it can then distribute as services or rents) in a way that makes it harder to track and less likely to be called in all at once, it can relieve immediate regime pressures. This goal is similar to diversifying debt in the private sector. While this creates a fiscal situation that is precarious, it can be perpetuated indefinitely in the absence of fiscal shocks. To do this, central governments can encourage borrowing and ensure the availability of credit, often through non-market-based mechanisms, using this lending to hide extra expenditures.
and bad debts. This allows central governments to implement popular policies like government worker protections and pension schemes, as in Brazil or Romania, or investments in health and education, as in Colombia or South Africa [57], without facing the full fiscal consequences of these spendthrift policies. Central governments then rely on the distribution of these debts, and the assumption that they will not be called in at once, to perpetuate this precarious scheme until fiscal crisis or other exogenous shocks make this impossible.

This strategy mirrors illegal accounting schemes in the business world, most famously identified with the Enron scandal, where a company distributes bad debts and investments to a variety of special purpose entities. In the case of Enron, these special purpose entities, however, were themselves guaranteed by Enron stock and financial guarantees, making Enron ultimately accountable for these debts despite effectively hiding them from investors [72]. This allowed Enron itself to keep its balance sheets clean while covering for large amounts of bad debt. This financial house of cards was able to continue, and benefit the owners, for more than a decade. Central governments similarly distribute extreme deficit spending among subnational units, and often again among state-owned enterprises, hiding these expenditures from central balance sheets and allowing unsustainable spending to continue unchecked.

One key to the success of this strategy is the availability of credit. While some subnational governments access credit through traditional debt markets, in many states central governments ensure this borrowing capacity through non-market-based mechanisms that are less likely to be subject to the usual evaluations that market-based lenders require. This has two advantages: first, it allows subnational fiscal circumstances to remain relatively opaque; and, second, it ensures the availability of additional funds to the subnational units that most need them, those with less productive capacity and ability to raise revenue. To ensure the availability of subnational credit,
central and subnational leaders have developed a variety of ingenious mechanisms. In many areas, particularly throughout the developing world, subnational borrowing is concentrated in the banking sector, often in national banks or state-sponsored development banks [57, pp.30-31]. In South Africa, the share of subnational debt held by the Development Bank of Southern Africa nearly doubled between 1997 and 2000, while in Zimbabwe government loans have made up nearly 90 percent of local government borrowing for capital development, largely through the General Loan Development Fund and the National Housing Fund [57, pp.325; 343-344]. Indonesia has relied on two centrally-administered programs to ensure subnational credit availability, the Regional Development Account and Subsidiary Loan Agreements, and around two-thirds of subnational units had borrowed from these programs at below market rates by 1999. At that point, total arrears to these programs stood at above 40 percent [57, p.447]. Central governments may also use a variety of approaches to require private lenders to deal with subnational units. Zimbabwe has for many years required institutional investors to keep 45 percent of their holdings in specific classes of assets, including long-term central government, local government, and parastatal-issued bonds [57, p.341].

Last, and most extreme, China provides an example of a state in which subnational borrowing is technically forbidden but subnational units have managed to access huge amounts of government-sponsored debt off-budget. In this case, there is a double shell game where overall government expenditures are hidden from central balance books by shifting them to subnational units and then hidden from subnational balance books by placing them in nominally independent government-owned entities. These special purpose vehicles themselves often then take out debt that is lent yet again to their parent governments, enhancing the perspective that these debts are ultimately the responsibility of the Chinese government while keeping official government balance
sheets clean. Some estimates suggest that these off-budget expenditures are equal in scale to formal subnational government activities [57, p.105]. Making this more troublesome is that these loans are contributing to a general problem with bad loans in the Chinese banking system. In 2004 non-performing loans were estimated at about 24 percent of bank balances [57, p.388]. As these examples attest, in many countries, particularly in the developing world, central governments have not just allowed but have directly ensured access to lines of credit for subnational units often for entities and projects that would find obtaining credit on the open market difficult. Ensuring subnational access to credit and retaining even indirect central control over this process allows central leaders to encourage expanded spending without affecting central budget balance.

Shifting expenditures and deficits to subnational units is only valuable to central leaders if subnational debts are harder to track and less likely to be noticed than central debts, and there is some evidence that this is true. Subnational accounting conventions are less developed and more opaque than for central governments, and there is often a lack of technical expertise to implement what conventions there are. As a result, subnational fiscal circumstances can be difficult to disentangle, even for would-be lenders. The World Bank has found that, in South Africa, for example, a number of “municipalities run budget deficits—while disguising them with formal budgets that unrealistically inflate revenues to achieve budget ‘balance’” [57, 328]. In fact, when lending becomes more marketized, regular and transparent financial statements and reporting are among the first changes that lending institutions tend to require [64]; [57, pp.22-23]. In addition, subnational debts are distributed across state and provincial levels, municipal governments, and, often, state-owned enterprises. They are also held across a variety of funding mechanisms, from multiple government banks and state-sponsored development banks, to municipal and provincial bonds, to
arrears to service providers and employees [57]. This piecemeal distribution of debt, both geographically and by type, can make a full accounting extremely difficult. For example, when it became clear that local debts in China were going to require central intervention, the first task was to design a program to determine how much subnational debt existed [133].

The general lack of availability of subnational debt figures on an international scale also suggests that the average international observer, including the IMF and World Bank, is uninterested in or unable to gather systematic data on subnational debt levels. While figures for government debt loads are widely available through a variety of government and nongovernmental sources, they almost always include only debt at the central government level. Outside of the European Union (and even that is relatively recent) aggregate government debt levels accounting for subnational debts are not available. In addition, comparable figures for specifically subnational debt (either by individual unit or in the aggregate) are also unavailable for most countries. Generally, the closest substitutes available are figures on subnational budget balance, derivable from IMF Government Finance Statistics. This, however, does not allow for tracking debt loads over time or understanding where and how debt loads are carried.

With subnational debt levels neither readily available nor widely reported, both domestically and internationally, it is unsurprising that taxpayers and organizations are less attuned to them than they are to central debt levels. What is surprising is that it appears that debt ratings agencies themselves may not be attentive to the scale of subnational debt. In his 2005 book, Rodden presents data that suggests that, in rating subnational units, debt ratings agencies consider central fiscal characteristics, suggesting an expectation of central bailouts for subnational units. On the other hand, a preliminary analysis suggests that the opposite is not true. In determining central debt ratings, central deficit levels play a role but subnational deficits are not
taken into account. While central budget balance figures are of the expected sign and marginally statistically significant, the coefficients for subnational deficits are not significant, and in fact take the wrong sign (see Table 1). If debt ratings agencies and other organizations watch central deficits for signs of fiscal soundness but are blind to subnational deficits, it is simply a logical response for central governments to reduce central deficits (or slow their growth) at the expense of subnational fiscal balance.

Table 4.1: Effect of Central and Subnational Deficit on Debt Ratings

<table>
<thead>
<tr>
<th></th>
<th>(1)</th>
<th>(2)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Foreign Debt Rating</td>
<td>Foreign Debt Rating</td>
</tr>
<tr>
<td>Central deficit/surplus (pct of GDP)</td>
<td>0.0238* (0.0139)</td>
<td>0.0409* (0.0225)</td>
</tr>
<tr>
<td>GDP/capita (thousands USD)</td>
<td>0.121** (0.0199)</td>
<td>0.141** (0.0236)</td>
</tr>
<tr>
<td>Subnational deficit/surplus (pct of expenditure)</td>
<td>-0.0886 (0.152)</td>
<td></td>
</tr>
<tr>
<td>Constant</td>
<td>7.292** (0.283)</td>
<td>7.252** (0.211)</td>
</tr>
<tr>
<td>Observations</td>
<td>351</td>
<td>123</td>
</tr>
</tbody>
</table>

Standard errors in parentheses
Models use fixed effects
* p < 0.1, ** p < 0.05

An additional facet to shifting government debts to subnational rather than central budgets involves the importance of timing in bailouts or expected bailouts. The logic of the soft budget constraint works because subnational debts are understood to be, in a fundamental sense, central debts. Subnational leaders understand subnational deficits to be essentially fictitious, as they will inevitably be taken on by the center. In a sense, under a true soft budget constraint subnational debts cannot exist at all because they are underwritten by central promises. This dynamic creates the
incentives necessary for subnational overspending by assuring subnational leaders that they are not responsible for the debts they accrue. If central and subnational leaders agree that subnational debt is ultimately central debt, the advantage of accruing it at the subnational level comes from assumptions about when debt will come due or become unsustainable. While subnational governments understand their debts to be implicitly underwritten, these debts remain on subnational ledgers until they are called in. It is only when precarious subnational situations become dangerous that central governments step in to actually provide funds to pay creditors, rectify wage arrears, or cancel subnational debts to the center. Decentralizing deficits is simply another way of diversifying risk. Central governments are betting that subnational units will require bailouts at different times so that the application of these debts to central ledgers happens piecemeal over time, rather than all at once. While economic crisis and other exogenous events may prove this to be an unwise wager, in the short-term spreading these debts may reduce pressure on central budgets. Further encouraging this strategy, it is precisely economic crisis and exogenous events that are most likely to reveal the fiscal weaknesses created by this plan, so leaders may be able to politically weather the fiscal crisis by blaming exogenous events rather than their own poor planning.

In short, like Enron-style business practices, this strategy creates a fiscal house of cards that may collapse utterly if challenged but in the meantime significantly benefits all involved. Central governments support public financial institutions, which are nominally independent and financially unsustainable. These then lend to subnational governments that are themselves financially unsustainable, and subnational units may well re-lend this money again. Each of these debts is fully backed by central or subnational governments, but only a small fraction ever show up officially on central books. Such a strategy could be strongly in central leaders’ interests, at least in the
short term, and would suggest that often subnational debts are not an accident of institutional design but are, instead, the result of deliberate central strategy. This is not a haphazard effect caused by a few rogue provinces but a concerted effort with significant fiscal consequences.

However, both the traditional institutional explanation for increased subnational debt, as exemplified by Rodden, and the strategic understanding suggested here predict that higher subnational borrowing authority along with higher subnational dependence will be associated with higher subnational deficits. Distinguishing this theory from the institutional theory—the evidence for which relies primarily on this relationship—requires careful consideration. I use two approaches to determine whether large subnational deficits are primarily a result of perverse institutional incentives or central strategies. First, I examine whether increased subnational deficits follow a logical incentive structure for central governments. If central governments are using subnational deficits as a substitute for central deficits, subnational deficits should be higher where expenditures are more decentralized, but not where revenues are more decentralized. This follows because decentralized expenditures indicate an offloading of services while decentralized revenues (including transfers) suggest a more general administrative decentralization. Similarly, subnational deficits should be higher where central expenditures on social services are lower, because central governments are substituting subnational social service provision (and its related deficits) for central efforts and expenditures. Next, I examine the relationship between subnational deficits and central deficits. If central governments are offloading deficits to subnational levels to reduce either the level or the growth of their own deficits, increases in subnational deficits should be associated with lower levels of central deficits.
4.4 Analysis

4.4.1 Hypotheses

Strategic Expenditure Shifting: Decentralization

To support the argument that subnational deficits are a strategic choice by central governments, I first look for empirical evidence that increases in subnational deficits follow a pattern that reflects centrally incentivized spending, specifically central offloading of expenses and substitution of subnational expenditures for central expenditures. If central governments are allowing or encouraging subnational deficits as a means of managing central deficits, we should expect to see higher subnational deficits where expenditures are more decentralized and where the center spends less on social services.

The first of these claims, that subnational deficits may be higher where expenditures are more decentralized, would indicate that central governments have used decentralization of programs and services to shift the debt burden downward. A lack of relationship here would suggest that central governments may have decentralized programs and services for service delivery and efficiency purposes and have simultaneously decentralized the necessary revenues, either through transfers or taxing authority. This relationship is made particularly clear if decentralization of expenditures has a different effect than decentralization of revenues; if decentralization of both expenditures and revenues leads to increased subnational deficits we may conclude that the increased deficits are simply the result of more general decentralization processes, supporting the institutional explanation for subnational debt. If, however, decentralization of expenditures has a negative effect on subnational budget balance while revenue decentralization has a positive or no effect, this suggests the decentralization of expenditure responsibilities in particular is related to increased subnational
deficits. This would lend support to the idea that expenditure decentralization may be used by central governments for expenditure offloading and that this, rather than institutional pressures, causes increased subnational deficits. This can be summarized in the following hypothesis:\(^3\)

**Hypothesis 4.** *Expenditure decentralization has a negative relationship with subnational surpluses, while revenue decentralization has no relationship or a positive relationship with subnational surpluses.*

**Strategic Expenditure Shifting: Social Expenditures**

An additional test of whether subnational expenditures and deficits are substituting for central expenditures involves examining the relationship between subnational deficits and central expenditures on social services. Central governments that have higher social service expenditures are less likely to be using subnational budgets to augment insufficient levels of central spending. On the other hand, central governments that spend less on social services either per person or as a percent of GDP are more likely to be shifting these costs to subnational units. Thus we would expect subnational deficits to increase in these cases. This can be summarized in the following hypothesis:

**Hypothesis 5.** *Central social service expenditures have a positive relationship with subnational surpluses.*

\(^3\)While this theory discusses subnational deficits, the data on deficits are structured as total subnational budget balance. Thus, positive numbers indicate surpluses and negative numbers indicate deficits. The hypotheses throughout this paper are structured to reflect that, though I continue to discuss subnational deficits.
**Subnational and Central Deficits**

A final approach to examining whether central governments may use subnational deficits to manage central deficits is to explicitly examine the relationship between subnational and central deficits. If subnational deficits are meant to substitute for central deficits, we would expect increases in subnational deficits to be associated with lower levels of central deficits. Thus, subnational deficits increase so that central deficits may be smaller. Put simply, we would expect that:

**Hypothesis 6.** Increases in subnational surpluses have a negative relationship with central surpluses.

**4.4.2 Data and Results**

The empirical models presented here use a cross-national time series dataset with data over the years 1995-2008. While some models have additional observations drop out, the available data includes 357 observations from 56 countries.\(^4\) While this does indicate significant missing data, a review of the country years included shows a variety of development levels, regime types and locations. In addition, non-response is generally a concern for lower-development states and non-democracies, precisely the states that are most likely to face limited resources and short time-horizons. Thus, if anything, the limited data availability is more likely to understate than overstate the argument presented here. Fiscal indicators, including subnational deficits, expenditure decentralization, and central social service expenditures are derived from the IMF’s *Government Finance Statistics (GFS)* while a variety of country-level control variables are taken from the *World Development Indicators* [83, 172].

\(^4\)See Appendix B for list of country years included.
While much of the theory presented and referenced here discusses subnational debt, the empirical portions of this study use measures of subnational deficit or surplus instead, for several reasons. First, as discussed above, the availability of reliable subnational debt figures is limited or non-existent, even for many countries with functioning debt markets. In addition, while debt figures would be useful in addressing questions of debt levels, in examining the ongoing process by which central governments offload problematic debt to subnational units marginal additions to debt may be more helpful in understanding this relationship than aggregate debt levels would be. Additionally, subnational deficit or surplus measures, rather than total debt measures, are also helpful when including data from developing countries, where subnational access to official debt markets is practically limited and subnational debt may take the form of delayed payments, wage arrears, and other informal debt arrangements.

All of the regressions presented in tables 2-5 are GLS pooled cross-sectional models. For each specification, I present models with and without clustered standard errors. All of the regressions presented are GLS pooled time-series cross-sectional models. For all models, I present specifications with and without clustered standard errors.\(^5\) All of the models are presented using country fixed effects.

STRATEGIC EXPENDITURE SHIFTING: DECENTRALIZATION AND SUBNATIONAL DEFICITS

To test the relationship between expenditure decentralization and subnational surpluses, I regress subnational surplus (or deficit) on expenditure decentralization. I include percentage of total government revenue recorded at the subnational level to

\(^5\)While clustering may be advisable because errors are likely to be correlated by province, clustered standard errors with a small number of clusters may be downward biased [170]; thus I present models with both clustered and unclustered errors.
distinguish between the effects of expenditure decentralization and those of revenue decentralization. In some models I control for total tax revenues and total government spending as a percent of GDP to account for general country-level tendencies toward taxation or spending.\(^6\) I also include total transfers as a percent of subnational expenditures to control for subnational fiscal dependence as well as logged GDP per capita and percent urban to control for general fiscal health and demand for social services.\(^7\) Subnational surpluses or deficits are calculated by subtracting total subnational expenditures from total subnational revenue and are measured as a percentage of total subnational expenditures. This measure accounts for both provincial and local revenues and expenditures indicators. Expenditure decentralization is measured as the percentage of total government expenditures that are made at a subnational level while revenue decentralization is the percentage of total government revenues recorded at a subnational level; these indicators also account for both provincial and local spending. The measure of revenue decentralization includes both local taxes and intergovernmental transfers as subnational revenue.

As seen in table 4.2, the regression results support the hypothesis that expenditure decentralization has a negative relationship with subnational surpluses, while revenue decentralization has a positive relationship with subnational surpluses. As expected, the regression results suggest that when expenditure decentralization is higher, subnational surpluses are lower (or subnational deficits are higher). This result is statistically significant at the 0.05 level for models that include revenue decentralization and those that use non-clustered standard errors. Revenue decentralization, on the other hand, is associated with greater subnational budget balance and lower deficits.

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\(^6\)Because of the large number of observations dropped when revenue decentralization and total tax revenue are included, I report results both with and without these variables.

\(^7\)Whether the state was unitary or federal was tried in these models, but dropped out of some models as perfectly collinear and was not significant in the others.
a result that is also statistically significant at the 0.05 level. In short, holding total
tax revenues constant, when a greater percentage of revenues are recorded at a subna-
tional level, subnational governments maintain lower deficits. Increased subnational
deficits do not seem to be an effect of fiscal decentralization generally, which means
that only when central governments offload expenditures without also decentralizing
revenue streams does decentralization cause ballooning subnational debt.
Table 4.2: Strategic Logic: Effects of Decentralization

<table>
<thead>
<tr>
<th></th>
<th>(1) Subnational surplus</th>
<th>(2) Subnational surplus</th>
<th>(3) Subnational surplus</th>
<th>(4) Subnational surplus</th>
</tr>
</thead>
<tbody>
<tr>
<td>Subnational expenditures (pct total)</td>
<td>-0.0186** (0.00373)</td>
<td>-0.0186** (0.00430)</td>
<td>-0.00524** (0.00159)</td>
<td>-0.00524 (0.00421)</td>
</tr>
<tr>
<td>Subnational Revenue (pct total)</td>
<td>1.997** (0.427)</td>
<td>1.997** (0.514)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Tax Revenue (pct GDP)</td>
<td>-0.000841 (0.000738)</td>
<td>-0.000841** (0.000337)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Government spending (pct GDP)</td>
<td>0.00142 (0.000886)</td>
<td>0.00142** (0.000399)</td>
<td>0.000300** (0.0000977)</td>
<td>0.000300** (0.000121)</td>
</tr>
<tr>
<td>Transfers (pct subnational expenditures)</td>
<td>0.450** (0.110)</td>
<td>0.450** (0.139)</td>
<td>0.850** (0.0276)</td>
<td>0.850** (0.0627)</td>
</tr>
<tr>
<td>Logged GDP/capita</td>
<td>0.520** (0.0863)</td>
<td>0.520** (0.0597)</td>
<td>0.0865** (0.0351)</td>
<td>0.0865 (0.0742)</td>
</tr>
<tr>
<td>Urban Population (pct)</td>
<td>-0.0102 (0.00619)</td>
<td>-0.0102 (0.00668)</td>
<td>-0.0111 (0.00737)</td>
<td>-0.0111 (0.0117)</td>
</tr>
<tr>
<td>Constant</td>
<td>-4.133** (0.710)</td>
<td>-4.133** (0.604)</td>
<td>-0.205 (0.522)</td>
<td>-0.205 (1.029)</td>
</tr>
<tr>
<td>Observations</td>
<td>68</td>
<td>68</td>
<td>357</td>
<td>357</td>
</tr>
</tbody>
</table>

Standard errors in parentheses
All models use country fixed effects, with clustered standard errors in models 2 and 4
A Hausman test indicates fixed effects is necessary
(Chi²(7)=75.17 for models with revenue decentralization; Chi²(6)=29.77 for those without)
* p < 0.1, ** p < 0.05
On the other hand, holding total government spending constant, as more government spending is shifted away from central levels and toward subnational levels, subnational budget balance suffers. Increased subnational spending is not accompanied by increased transfers or local tax revenues. This dynamic indicates that expenditure decentralization and shifts toward local service provision do not simply change the locus of service provision they change who is liable for those expenditures and their associated deficits, and this change is to the advantage of central government budget balance. The institutional explanation for increased subnational debts would suggest that decentralization generally, including increased expenditure decentralization and transfers, would be associated with higher levels of subnational debt. Instead, these results indicate that expenditure decentralization but not revenue decentralization is associated with increased subnational debt. This lends more credence to the idea that central expenditure shifting rather than overall decentralization is driving subnational deficits.

**Strategic Expenditure Shifting: Social Service Expenditures and Subnational Deficits**

Another way to examine whether central governments are encouraging subnational deficits by shifting service responsibilities downward is to explicitly examine the relationship between social service expenditures and subnational deficits. To do this I regress subnational deficits on central service expenditures. I include models where central social service expenditures are calculated as a percent of GDP and those where they are calculated as overall per person expenditures. In addition, I present models that include social security and welfare expenditures as part of central social service expenditures as well as those that do not. Each of these models also includes non-social service expenditures by the center to distinguish between the effects of central
service and non-service expenditures. As above, they include controls for logged GDP per capita and percent urban to account for general fiscal health and demand for social services. These sets of models include an additional control for whether the state is unitary or federal.

As seen in tables 3 and 4, the regression results estimating the effect of central social service expenditures on subnational budget balance support the hypothesis that in states where the central government spends more on social services, subnational governments are likely to have lower deficits (or higher surpluses). These results hold whether measuring social service expenditures per person or as a percent of GDP and regardless of whether social security and welfare expenditures are included as social service expenditures. While some models using non-clustered standard errors miss statistical significance, the models using clustered standard errors are consistently significant at least at the 0.05 level. In other words, all else equal, when central governments take on higher levels of social service expenditures subnational budget balance is better. This suggests that central service expenditures can, in a sense, directly substitute for subnational spending (and overspending) on services.

Note also that the estimated effect of central social service expenditures on subnational deficits appears to be strongly different than the effect of other types of central expenditures on subnational deficits. In many of the models presented, it appears that there is no relationship between non-social-service expenditures at the central level—that is, central expenditures on defense, public order, economic activities, etc.—and subnational deficits. In the models in which non-social-service expenditures are statistically significantly related to subnational budget balance, the effect is negative; higher central expenditures in areas other than social services are associated with higher subnational deficits. While higher levels of central government spending overall are associated with less disciplined subnational spending, then, central expen-
diture commitments to social services (which most easily substitute for subnational spending) have a uniquely positive effect on subnational budget balance.
Table 4.3: Strategic Logic: Effects of Social Service Expenditures as Percent of GDP

<table>
<thead>
<tr>
<th></th>
<th>(1) Subnational surplus</th>
<th>(2) Subnational surplus</th>
<th>(3) Subnational surplus</th>
<th>(4) Subnational surplus</th>
</tr>
</thead>
<tbody>
<tr>
<td>Central Service Expenditures (pct GDP)</td>
<td>0.00172*</td>
<td>0.00172**</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.00101)</td>
<td>(0.000444)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Central Services Expenditures (pct GDP excluding Social Security)</td>
<td></td>
<td></td>
<td>0.00142</td>
<td>0.00142**</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>(0.000984)</td>
<td>(0.000438)</td>
</tr>
<tr>
<td>Non-Social Service Expenditures (pct GDP)</td>
<td>-0.000372</td>
<td>-0.000372</td>
<td>-0.00000595</td>
<td>-0.00000595</td>
</tr>
<tr>
<td></td>
<td>(0.000746)</td>
<td>(0.000353)</td>
<td>(0.000630)</td>
<td>(0.000272)</td>
</tr>
<tr>
<td>Transfers (pct subnational expenditures)</td>
<td></td>
<td></td>
<td>0.466**</td>
<td>0.466**</td>
</tr>
<tr>
<td></td>
<td>(0.0808)</td>
<td>(0.197)</td>
<td>(0.0811)</td>
<td>(0.198)</td>
</tr>
<tr>
<td>Logged GDP/capita</td>
<td>0.222**</td>
<td>0.222**</td>
<td>0.222**</td>
<td>0.222**</td>
</tr>
<tr>
<td></td>
<td>(0.0543)</td>
<td>(0.0868)</td>
<td>(0.0549)</td>
<td>(0.0880)</td>
</tr>
<tr>
<td>Urban Population (pct)</td>
<td>-0.0162</td>
<td>-0.0162</td>
<td>-0.0166</td>
<td>-0.0166</td>
</tr>
<tr>
<td></td>
<td>(0.0110)</td>
<td>(0.0149)</td>
<td>(0.0111)</td>
<td>(0.0149)</td>
</tr>
<tr>
<td>Unitary state</td>
<td>0.0145</td>
<td>0.0145</td>
<td>0.0128</td>
<td>0.0128</td>
</tr>
<tr>
<td></td>
<td>(0.0726)</td>
<td>(0.0335)</td>
<td>(0.0732)</td>
<td>(0.0321)</td>
</tr>
<tr>
<td>Constant</td>
<td>-1.130</td>
<td>-1.130</td>
<td>-1.106</td>
<td>-1.106</td>
</tr>
<tr>
<td></td>
<td>(0.788)</td>
<td>(0.967)</td>
<td>(0.799)</td>
<td>(0.989)</td>
</tr>
<tr>
<td>Observations</td>
<td>240</td>
<td>240</td>
<td>240</td>
<td>240</td>
</tr>
</tbody>
</table>

Standard errors in parentheses
All models use fixed effects, with clustered standard errors in models 2 and 4;
A Hausman test indicates fixed effects is necessary
(Chi²(6)=28.32 for with social security model and Chi²(6)=62.79 for without social security model)
* p < 0.1, ** p < 0.05
<table>
<thead>
<tr>
<th></th>
<th>(1) Subnational surplus</th>
<th>(2) Subnational surplus</th>
<th>(3) Subnational surplus</th>
<th>(4) Subnational surplus</th>
</tr>
</thead>
<tbody>
<tr>
<td>Central Service Expenditures (per person)</td>
<td>0.000248</td>
<td>0.000248**</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Central Service Expenditures (per person without social security)</td>
<td></td>
<td></td>
<td>0.000206</td>
<td>0.000206**</td>
</tr>
<tr>
<td>Central Non-service Expenditures</td>
<td>-0.0000975</td>
<td>-0.0000975**</td>
<td>-0.0000424</td>
<td>-0.0000424</td>
</tr>
<tr>
<td>Transfers (pct subnational expenditures)</td>
<td>0.461**</td>
<td>0.461**</td>
<td>0.462**</td>
<td>0.462**</td>
</tr>
<tr>
<td>Logged GDP/capita</td>
<td>0.223**</td>
<td>0.223**</td>
<td>0.221**</td>
<td>0.221**</td>
</tr>
<tr>
<td>Urban Population (pct)</td>
<td>-0.0150</td>
<td>-0.0150</td>
<td>-0.0155</td>
<td>-0.0155</td>
</tr>
<tr>
<td>Unitary state</td>
<td>0.0228</td>
<td>0.0228</td>
<td>0.0203</td>
<td>0.0203</td>
</tr>
<tr>
<td>Constant</td>
<td>-1.212</td>
<td>-1.212</td>
<td>-1.168</td>
<td>-1.168</td>
</tr>
<tr>
<td>Observations</td>
<td>240</td>
<td>240</td>
<td>240</td>
<td>240</td>
</tr>
</tbody>
</table>

Standard errors in parentheses
All models use fixed effects, with clustered standard errors in models 2 and 4;
A Hausman test indicates fixed effects is necessary
(Chi^2(6)=38.05 for with social security model and Chi^2(6)=38.79 for without social security model);
All per-person expenditures are measured in thousands of dollars
* p < 0.1, ** p < 0.05
In terms of the control variables, for models testing the effect of decentralization and those testing the effect of central service expenditures most behave as expected when there are strong expectations. While higher transfer levels and higher GDP are associated with higher subnational surplus, a larger urban population is associated with subnational deficits, possibly because of higher demand for social services. The positive effect of overall government spending (as a percent of GDP) on subnational surplus in the fiscal decentralization models may be a bit surprising, but may be reflecting higher overall government capacity, including taxing capabilities. As expected from the existing literature, unitary states are associated with higher subnational surpluses, though this is not consistently statistically significant; however, this lack of statistical significance may be the result of limited variation because of the use of fixed effects.

Taken together these results do suggest that subnational deficits are affected by central expenditure offloading that indicate that the center is strategically using subnational budgets, though the data are not definitive. When central governments expect more of subnational units and contribute less themselves, subnational deficits increase. Either central governments are unaware of the effects of increased responsibilities and unfunded mandates on subnational budget balance or they are aware and accept this result as a calculated risk. While central governments are unlikely to fail to understand the consequences of their actions, in either case, this does not suggest a world in which subnational governments expand deficits and accrue debt at the expense of a helpless center.

**Subnational Deficits and Central Surpluses**

To test the relationship between central budget balance and subnational budget balance, I regress central deficits on changes in subnational surpluses or deficits. Central
surpluses or deficits are calculated by subtracting total central expenditures from central revenues and are measured both as a percentage of central expenditures and as a percentage of GDP. As above, subnational surpluses or deficits are measured by subtracting subnational expenditures, encompassing both local and provincial units, from subnational revenues. Changes in subnational deficits are measured year-on-year and included with a one-year lag. These models also include the level of subnational surplus as a control, along with total GDP, percent urban, and total government spending as a percent of GDP to account for general economic climate and overall government spending propensity.

As seen in Table 5, the regression results indicate that there is a negative relationship between increases in subnational surpluses and levels of central surplus. This means that as subnational deficits increase (or subnational surpluses decrease), central budget balance improves.

Of course, levels of central and subnational surplus, which are based on similar background economic and political conditions, are positively associated, though imperfectly; a one percentage point increase in subnational surplus is associated with only a 0.28 percentage point increase in central surplus. A change in subnational surplus, however, works in the opposite direction as stronger central surpluses are associated with weaker subnational budget balance. This suggests that central governments do gain some fiscal advantage from the expenditure offloading suggested by the previous section’s analysis. When subnational units increase deficits some of that change goes to shore up central budget balance. When placed in a tight spot, central governments can simply reduce central social service expenditures and increase subnational expenditure responsibilities. Although this will increase subnational deficits, is likely to lead to decreased central deficits.
Table 4.5: Central Deficit Relationship with Subnational Deficit

<table>
<thead>
<tr>
<th></th>
<th>(1) Central Surplus</th>
<th>(2) Central Surplus</th>
</tr>
</thead>
<tbody>
<tr>
<td>Change in Subnational Surplus</td>
<td>-0.118*</td>
<td>-0.118*</td>
</tr>
<tr>
<td></td>
<td>(0.0622)</td>
<td>(0.0701)</td>
</tr>
<tr>
<td>GDP, PPP (Constant International USD)</td>
<td>2.18e-13**</td>
<td>2.18e-13*</td>
</tr>
<tr>
<td></td>
<td>(6.76e-14)</td>
<td>(1.10e-13)</td>
</tr>
<tr>
<td>Subnational surplus</td>
<td>0.280**</td>
<td>0.280*</td>
</tr>
<tr>
<td></td>
<td>(0.0713)</td>
<td>(0.149)</td>
</tr>
<tr>
<td>Urban Population (pct)</td>
<td>-0.106**</td>
<td>-0.106</td>
</tr>
<tr>
<td></td>
<td>(0.0165)</td>
<td>(0.0735)</td>
</tr>
<tr>
<td>Government spending (pct GDP)</td>
<td>0.000651**</td>
<td>0.000651</td>
</tr>
<tr>
<td></td>
<td>(0.000182)</td>
<td>(0.000394)</td>
</tr>
<tr>
<td>Constant</td>
<td>6.142**</td>
<td>6.142</td>
</tr>
<tr>
<td></td>
<td>(0.973)</td>
<td>(4.331)</td>
</tr>
<tr>
<td>Observations</td>
<td>299</td>
<td>299</td>
</tr>
</tbody>
</table>

Standard errors in parentheses
Both models use fixed effects, with clustered standard errors in model 2;
A Hausman test indicates fixed effects is necessary (Chi^2(4)=43.70)
* p < 0.1, ** p < 0.05
Another thing to note about all of the results presented here is that, because of the composition of the dataset, they may be understating the results for the relevant cases. As described in the theory section I would expect that in some cases the institutional explanation is, indeed, at work. As I argue, the strategic explanation presented here is more likely to be correct in developing countries or those with less marketized subnational debt markets. The dataset used here, however, includes both cases where the explanations suggested here is likely to be at work as well as those where the institutional explanation is more likely. More process and quantitative work going forward may better identify cases where the logic of offloading and hiding debt is most likely to be at work. Because the data used here includes both types of cases, however, the estimates of the actual effect may well be understated.

4.5 Discussion

When decentralization, federalism, and vertical fiscal imbalance are associated with increased subnational debt loads, is this the unintended result of perverse institutional incentives, or is this a strategic, if short-sighted, choice by central leaders? While both may be true in various circumstances, I provide evidence that, in some cases, central leaders tacitly encourage subnational deficits as a way to shift deficit spending from more readily visible central budgets to relatively invisible subnational budgets. While it is difficult to directly test claims about central intentions and decision-making processes, there are several testable implications presented here that provide specific support for the theory of strategic subnational deficits.

First, the fact that expenditure decentralization seems to have a unique relationship with subnational deficits, one that differs from the relationship with revenue decentralization, suggests that, contrary to what would be expected based on the
institutional explanation for subnational deficits, increases in subnational deficits are not the result of general decentralization processes. While it is possible that expenditure decentralization appears to grow because subnational units independently spend more, rather than because their responsibilities are larger, that effect would have to be quite large to significantly drive observed differences in expenditure decentralization. In addition, the fact that the measure of subnational revenues, which shows no relationship with subnational deficits, includes transfers from other levels of government suggests that subnational dependence on transfers does not drive the relationship between decentralization and subnational deficits.

The observed relationship between subnational deficits and central social service expenditures distinguishes the theory that subnational deficits are strategic tools for the center even more clearly from alternatives. If subnational deficits are the result of independent selfish decision-making by subnational units, there is no reason to suppose that they would be sensitive to particular types of central spending. Even if central social service spending did subsidize what would otherwise be subnational expenditure responsibilities, a subnational leader exploiting the common pool for political gain would be expected to simply increase spending elsewhere. While it may be reasonable to expect that subnational spending (and deficits) would be sensitive to larger issues of government spending, this does not appear to be the case. Instead, subnational budget balance depends specifically on central expenditure commitments to social services, suggesting a direct trade-off between spending at the central and the subnational levels.

Supporting this further is the apparent relationship between central and subnational budget balance. While central and subnational surplus levels, which are based on shared exogenous influences, vary together, increases in subnational deficits are associated with smaller central deficits. If central and subnational budget balance are
determined based on independent decisions made by independent leaders, there is little reason to expect that a change in one would be directly and, especially, negatively related to the other. In general, if these are independent, one would expect them to be either unrelated or to be positively related, reflecting additional omitted factors. One explanation for divergent trends here could be that there is some evidence that central expenditures may be counter-cyclical while subnational expenditures are strongly pro-cyclical (Rodden and Wibbels 2010); however, while this would explain diverging trends in central and subnational spending, there is no reason to believe that subnational units would restrict their deficits in tough economic times. In short, the existence of a negative relationship between subnational deficit increases and central deficits suggests strongly that the processes determining these deficits are not independent. This, particularly along with the additional results above, lends support to the idea that subnational budgets are available for strategic use by central governments.

4.6 Conclusion

If subnational deficits are, in at least some instances, the result of central shifting of deficit spending away from central budgets and into the obscurity of subnational budgets, rather than unintended effects of perverse incentives created by institutional structure, what does this mean for the study of fiscal federalism? First, this suggests that institutional fixes are unlikely to be successful at limiting subnational debt, both because they are unlikely to be implemented and because, even if implemented, they may only obscure larger issues. This means that, unless central governments are actually committed to curbing or taking ownership of overall deficits, no manner
of credible anti-bailout commitment or shift toward own-source revenue is likely to ensure subnational budget balance.

Moving beyond the traditional institutional approach, these results suggest that central and subnational budget balance cannot and should not be understood independently. When evaluating overall fiscal health, estimating the economic effects of government-sector budget balance and austerity, or determining the credit-worthiness of governments, the European Union is essentially alone in taking into account both central and subnational budgets. If central governments use subnational budgets as extensions of their own budgets, however accounting for only central budget balance is not an approach that focuses on a separable part of a larger system but instead ignores fundamental information. Accounting for this information, it is possible that a variety of institutions are significantly underestimating the overall risk of fiscal crisis across a number of states. This also suggests that an undue focus on central deficits and debt levels, without accounting for subnational budget balance, may itself introduce perverse incentives.

Last, understanding the full extent of the links between central and subnational budgets, and the reciprocal relationship contained therein may help us better understand the totality of the political and economic relationship between center and periphery. If central leaders need subnational cooperation, what sort of leverage might that give subnational leaders? Do central fiscal incentives for expenditure decentralization ultimately affect subnational independence? Do they affect the quality of services provided? Moving forward, paying attention to the interconnection of subnational and central budgets may open up areas for further understanding of the myriad ways in which central and subnational affairs remain interconnected, even when nominally independent.
5.1 The Intergovernmental Relations Toolkit

Governing is neither a simple nor a passive proposition. Leaders must determine plans and policies for pleasing supporters and quelling dissent; develop systems and approaches for implementing these plans; and marshal and deploy resources in service of these efforts. In doing this, they draw on a wide variety of strategies and tools, including but certainly not limited to parties and elections, bureaucratic delegation, and taxation. Through exploring the approaches that states and leaders have taken to interactions with subnational units, this dissertation has argued that intergovernmental relations provides another set of institutions and resources that central leaders use in their efforts to govern—an intergovernmental relations toolkit.

As states attempt to impose effective, even rule and policies across spaces that encompass widely varying conditions and preferences, the demands of governance rise sharply. Reconceptualizing intergovernmental relations as a set of dynamic, adaptive strategies that states may use to expand, improve and consolidate governance (as opposed to sets of static institutions or points of discrete institutional change) better accounts for changes in decentralization and intergovernmental relations over time and also fruitfully integrates intergovernmental relations into larger issues of governance and rule. Understanding what is included in the intergovernmental relations toolkit and how it is used will shed light on questions of regime strength and resilience,
fiscal stability, policy implementation and convergence, and even state breakdown and rebellion. In this dissertation I have focused on three specific tools of intergovernmental relations: the use of decentralization in increasing state reach and authority; the use of intergovernmental transfers in inducing policy convergence; and the use of subnational budgets and debt in softening central budget constraints.

5.1.1 Tools for Increased Authority: Decentralization

As addressed in chapter two, decentralization—the transfer of resources and decision-making authority to subnational leaders—is in itself a tool for central leaders to increase their authority across the state. In situations of constrained resources, states can harness the efficiency advantages and relatively lower governance costs of decentralized governance to expand central authority and boost their ability to administer and monitor policy throughout the state. As the exploration of the Chinese case indicates, this not only involves empowering subnational leaders to execute, monitor and adjust policy but also requires the creation and use of strategies to monitor and control the actions of subnational leaders. That is, this tool requires effort and expertise to use effectively, and it has limits. In cases where agency costs are high, as in the Nigerian case, they may swamp the governance advantages of decentralization and it will prove an ineffective strategy for expanding central authority and governance capacity. Nevertheless, the opportunities that decentralization can offer in the proper circumstances provide an additional and powerful instrument for states to consider when working to improve or expand governance efforts.

5.1.2 Tools for Policy Convergence: Intergovernmental Transfers

As noted in chapter three, intergovernmental transfers act as another tool in the intergovernmental relations arsenal, particularly where the center’s institutional leverage
over subnational governments is limited. While prior work explaining intergovernmental transfers has explained them largely as technical policy tools or part of electoral strategies, the evidence presented here suggests that they also provide a tool to facilitate the center’s efforts to expand and implement particular policies. While subnational leaders and electorates have a variety of preferences, some of which are at odds with central goals, central governments can use intergovernmental transfers to encourage subnational leaders, particularly those that would otherwise be resistant to central policy preferences, to implement centrally-preferred policies. Despite variation in constituent preferences across the state, as seen in the Canadian case central leaders may bring about significant policy convergence through using intergovernmental transfers as a tool. And, as indicated by the formal model, while this tool is most useful in situations where the center’s institutional leverage over subnational government is limited (so, where policy responsibilities are effectively—generally constitutionally—divided between central and subnational governments) it can also be useful in other situations by allowing central governments to take advantage of the governance advantages of decentralization while still using intergovernmental transfers to exert influence over policy outcomes. In sum, intergovernmental transfers should be understood as a powerful source of leverage and influence that helps central governments achieve their preferred outcomes.

5.1.3 Tools for Fiscal Expansion: Subnational Debts

The last intergovernmental relations tool explored here is the use of subnational budgets and debt in softening central budget constraints. Most of the existing research on subnational budget balance and overspending assumes that the central government acts as a fall-back for overextended subnational governments and creates soft budget constraints for them. In chapter four I argue that, instead, subnational budgets
and subnational overspending can create soft budget constraints for central leaders, allowing them to encourage subnational spending (and overspending) to increase overall government expenditure without increasing central deficits or debts. This approach certainly creates problems in the long term, encouraging unsustainable debts that will eventually lead to calls for central bailout and, potentially, overall fiscal crisis. However, the intertwined nature of central and subnational budgets and spending provides an important short-term tool for central governments that wish to expand government spending and services without threatening electoral prospects or borrowing opportunities. When central governments use subnational budgets as extensions of their own budgets it offers significant political, policy and fiscal advantages as central governments try to extend governance and policies throughout the state.

Of course, these three tools represent only a portion of the intergovernmental relations toolkit. The opportunities that the institutions, actors, and relationships offered by intergovernmental relations open to central governments in their efforts to govern and assert authority are wide-ranging, and an understanding of the myriad ways in which central governments pursue their goals and interests through intergovernmental relations will shed additional light on subnational and central politics and governing arrangements. However, this examination of three significant tools afforded by intergovernmental relations both illuminates how important intergovernmental relations is as a venue for action by the center (rather than an inherently antagonistic set of institutions), and provides specific results that strengthen our understanding of intergovernmental relations and central governance efforts.
5.2 IMPLICATIONS

What implications do this understanding of intergovernmental relations and the specific effects reported here have for how we understand central and subnational politics and governance? Most broadly, if intergovernmental relations can and should be understood as a set of tools that central governments use in their governance efforts it suggests that sharp distinctions between politics and governance at central and subnational levels may be unhelpful and misleading. If intergovernmental relations provide additional strategies and sites for action for central leaders in pursuing larger political and governance goals then intergovernmental relations must be understood as part of, not set off from normal politics and governance. Intergovernmental relations is not a separate sphere of politics but is instead enmeshed with other sets of goals, strategies and networks. Furthering the conceptualization of how intergovernmental relations-based tools and strategies relate to, enhance, and substitute for other sets of tools and strategies will be an important area of future research.

In addition, the particular tools and results presented here suggest a complex interaction among elements of intergovernmental relations that is only hinted at in the substantive chapters of this dissertation. Taken together, this dissertation suggests that central governments adopt decentralization to increase their authority; that this control is increased by “paying" decentralized units to adopt centrally-preferred policies (and the central government pays more if the preferences of sub-units are further away); and that, at the same time, the central government shifts the burden of paying for public goods to the sub-units, leading them to run up higher deficits and debts over time. But these arguments not only give sketch of the relationship among decentralization decisions, intergovernmental transfers, and debt accumulation they also suggest evocative and productive ways in which these elements interact.
For example, chapter two establishes that central governments, particularly those facing high governance costs, can gain from decentralization but only if they can establish effective means of controlling the actions of subnational leaders. With low agency costs, made possible by effective control mechanisms, decentralization can expand central reach and authority. With high agency costs, caused by a dearth of effective control mechanisms, decentralization could quickly spiral out of control and is instead avoided. The case study of China provides some examples of possible control mechanisms, from party structure to personnel policies, but chapter three’s discussion of intergovernmental transfers supplies a more expanded account of one common control mechanism. States that have the fiscal and institutional resources to use intergovernmental transfers to encourage compliance from subnational leaders have established access to an important form of control over subnational decision-making and can thus be more comfortable choosing to expand their authority through decentralization, so long as the price is right.

Conceptualizing intergovernmental transfers as a tool for changing subnational decision-making also sheds light on how varying institutional structures can lead to different outcomes despite similar preferences and strategies. As established in chapter two, if central leaders can control subnational leaders, whether through intergovernmental transfers or by other means, they will be more likely to choose decentralization. However, this is always a cost-benefit analysis. Where the costs of control—directly, through intergovernmental transfers, or otherwise—are too high the center will simply refuse to decentralize. Under some institutional structures, though, central governments do not have this choice. In well-institutionalized federations, as in the case of Canada, the scope of action between central and subnational governments may be constitutionally delineated. In this case, the central government has no choice as to whether to empower subnational governments in the areas of health or education. As
chapter three suggests, central governments are then likely to invest more resources in influencing subnational outcomes and rely more heavily on intergovernmental transfers to do so. Without the option of simply keeping power and responsibility for themselves, and with limited direct means of controlling subnational leaders, intergovernmental transfers become the core tool for central governments working within particular institutional structures to exert influence over subnational outcomes.

Last, these arguments suggest an interesting outcome for the distribution of unsustainable subnational debts. If central governments encourage the accumulation of subnational debts to reduce their own budget strain but also strategically funnel resources to subnational leaders who disagree with them, this suggests that the areas that most quickly and dramatically accumulate unsustainable debts are likely to be subnational units that are politically the most similar to and friendly to central leaders and their preferences. While this possibility is not explicitly tested here and more empirical support is necessary to confirm this relationship, it is a logical implication of the arguments presented here. If true, this could have implications for the fiscal sustainability of subnational units that are most sympathetic to central goals and priorities. This, in turn, could have significant political implications, and this should be an avenue for further research.

Fundamentally, this dissertation provides an overview of some of the most important tools that intergovernmental relations furnishes to central governments, along with a framework for how these tools complement or substitute for each other in different institutional frameworks, and how they may change or exacerbate each other. The next step will be to gain a more comprehensive understanding not only of the contents of the intergovernmental relations toolkit but also of the function that each tool serves and how they relate to each other and to other types of governance tools and resources.
5.3 Scope of These Arguments

This dissertation draws on evidence from widely varying states, including Canada, Nigeria and China. These cases represent different regime types, degrees of development, and levels of institutionalization and state strength. While this variety suggests that the conceptualization of intergovernmental relations presented here can travel to many contexts, it is important to establish the scope of these arguments and why we should expect these relationships and mechanisms to be at play in diverse contexts.

5.3.1 Regime Type

Comparative politics work, particularly that which focuses on strategies for governance and rule, generally focuses on a particular regime type or on comparing regime types—strategies of rule and regime survival are generally operative in either democracies or authoritarian regimes, for the very good reason that the relationship between governments and citizens, and thus the basis for rule, are fundamentally different in authoritarian regimes and democratic regimes. In addressing these questions of intergovernmental relations, however, I do not make a distinction between strategies and tools for democratic leaders and those for authoritarians. This is because, while the relationship between citizen and government may differ for democratic and authoritarian regimes, subnational governance units mediate this relationship and, in important ways, sever it. Both central and subnational governments relate to citizens differently in democracies than they do in authoritarian regimes, but the relationship between central and subnational governments is hierarchical, not democratic, regardless of regime type.\(^1\) Because of this, the structure of the relationship between central and subnational units tends to be more similar than different, regardless of regime

\(^1\)In true confederations the relationship between subnational and central authorities may be democratic, but very few states are true confederations. See [103] for more on this.
type. I would argue, then, that interrogating the structural similarities or differences in the relationship between central and subnational powers is more relevant for determining whether two states’ intergovernmental relations are comparable than focusing on their regime type.

5.3.2 MECHANISMS AND CONTEXT

In this dissertation, the presentation of context, case-specific outcomes, and a language of individual agency juxtaposed against generalizable institutional theories and game-theoretic explanations also brings to the fore larger questions about how broadly these theories can be expected to travel and how to value structural explanations against context and individual agency. These are important questions that the field continues to grapple with, but in the case of this dissertation the goal is to illuminate specific mechanisms, relevant in particular relationships and incentive structures, that may manifest in different ways in a variety of contexts.

This suggests two specific implications for how this argument should be understood: first, the mechanisms presented here rely heavily on interpretations of the incentives facing both central leaders and subnational leaders. A focus on incentives, however, should not be understood to deny these leaders agency. Actors with different goals or values may well behave in ways that are unexpected and unexplained by the mechanisms described in this dissertation. However, institutions are structured to incentivize particular behaviors, assuming that most actors share in some common goals. These institutional and structural incentives, with both their intended outcomes and their unintended consequences, are often powerful motivators and drive the analysis in this dissertation. In addition, while not all of the mechanisms described here explicitly incorporate subnational leaders as separate actors they are always assumed
to have individual agency and decision-making capabilities. In these cases, the incentives and decisions that subnational leaders face are simply baked into the incentive structure guiding central decision-making.

In addition, the mechanisms of this dissertation, as conceived and described here, are intended to be both generalizable and context-dependent. What this means is that the structural relationships described here and the general outcomes they produce are common in the political world. Central leaders in hierarchical systems often face trade-offs between increased efficiencies and agency costs, search for strategies to influence related but independent entities, or choose between diversifying debt or controlling it. The particular contours of these relationships, however, vary. Context influences what specific strategies or approaches are available—for example, whether party organization, electoral incentives, intergovernmental transfers, or any number of other mechanisms for monitoring and controlling agents are feasible or relevant in a particular case—while the broader structure of the relationship remains. Thus, while I suggest that these mechanisms and understandings of intergovernmental relationships travel broadly identifying the context-specific elements that underlie and flesh out these relationships requires an understanding of the particular case.

5.3.3 Intergovernmental Relations and the United States

Because much of the existing work on intergovernmental relations is focused on the United States, a common question for all intergovernmental relations work is whether and how it relates to the U.S. case. This dissertation has focused on several cases outside of the U.S. not only because they better demonstrate the variety of contexts in which these mechanisms may be at work, but also because exploring less familiar cases can often be theoretically fruitful. However, the tools of intergovernmental relations presented here do have relevance for explaining the U.S. case and further exploring
that relevance may be a useful direction for future research. In particular, the U.S. federal government, generally through an expansive interpretation of the Commerce Clause, has often relied on central spending and shared cost programs to help direct and influence state policies, from highway funding and the drinking age [107] to Medicaid expansion under the Affordable Care Act [42], with varying levels of success. While particular policy areas and specific instances of central influence have been well-studied, broader questions remain. Developing a more comprehensive sense of how the federal government has strategically used intergovernmental transfers, conditional or otherwise, to affect subnational policy; whether and how this has affected the trajectory of intergovernmental relations and state policy; and how the effectiveness of these tactics vary across political contexts and policy areas could add both to our understanding of U.S. intergovernmental relations itself and how it compares to other systems.

In addition, while the U.S. government’s relatively long-term outlook (and its demonstrated anti-bailout commitment [129]) limits the extent to which the federal government relies on state budgets to expand services and spending, there is evidence that within states the proliferation of overlapping and special-purpose governments has increased overall spending and taxation [19]. Whether this proliferation has also increased overall local and municipal debt levels is an open question, but most of these overlapping and special-purpose governments have borrowing capabilities so it is well worth exploring. In short, while the empirical evidence presented in this dissertation does not engage the U.S. case, the theories and mechanisms it presents are relevant to the U.S. case, and how they manifest there will be an important avenue for future research.
5.4 Conclusion

When and why do states decentralize—and when and why do they resist doing so? How do central governments control or influence subnational policies and decisions? How do central governments understand and use intergovernmental relations in their larger governance efforts? How does intergovernmental relations constrain or enhance the projection of central authority? These are fundamental questions for understanding not just decentralization or intergovernmental relations but also basic questions of governance and state-building. The strongly institutional focus of previous work on decentralization and intergovernmental relations has obscured these issues, but this dissertation has argued that engaging with them will significantly strengthen our understanding of the mechanics of governance and policy implementation.

Through reconceptualizing intergovernmental relations as a sphere of relational, dynamic interaction between central and subnational authorities, and then exploring three specific arenas in which central leaders use intergovernmental relations to pursue their preferred goals and policies, I argue that intergovernmental relations provides an invaluable toolkit for central governments as they work to govern. Cataloging, administering, organizing and controlling populations and territories involves drawing on significant material and strategic resources, and understanding these resources and strategies is a core task for political scientists as we seek to explain how and why states govern as they do. The results presented here suggest that intergovernmental relations offer significant resources for central governments, if they can effectively use them. In doing so, these results provide key insights into how and why states empower, influence and control subnational units—and how and why intergovernmental relations should
be appreciated alongside other fundamental strategies for exerting state authority and governance.
Appendix A

Model Calculations

A.1 Model Form 1: Buying Policies

Subnational Decision-Making: Subnational leaders will choose to set policy at a limit set by the center only if the compensation they receive for doing so, $\phi_s$, is sufficient to make up for the difference between subnational policy preferences, $S$, and the policy limit, $\lambda$. Otherwise, they will set policy at the subnational ideal point, with certainty, because otherwise they will not be retained as leaders by the subnational electorate. For subnational electorates, the utility function is:

$$U_S(x) = -(x - S)^2 + \phi_s$$

Thus, because the compensation, $\phi_s$ is not transferred if policy is set at the subnational ideal point, the utility of policy set at $S$ is:

$$U_S(x) = -(S - S)^2$$

$$= 0$$

Subnational electorates will only accept policy set at a centrally-imposed limit, $\lambda$, and subnational leaders will only set policy there, then, if:
\[ U_S(\lambda, \phi_s) > U_S(S) \]
\[ -(\lambda - S)^2 + \phi_s > 0 \]
\[ \phi_s > (\lambda - S)^2 \]

Note that the utility increase experienced by the subnational electorate, \( \phi_s \), is not necessarily the same as the utility decrease experience by the center, \( \phi_c \), even for the same compensation package. Because of differences in resource availability, among other reasons, these may not be the same value.

**Central Decision-Making:** The center will choose to impose a policy limit if and only if the utility of imposing a limit is greater than the utility of not imposing a limit and simply accepting the subnational ideal point, or if:

\[ U_C(\lambda, \phi_c) > U_C(S) \]

The utility to the center of imposing a limit can be expressed as:

\[ U_C(\lambda, \phi_c) = -\lambda^2 - \phi_c \]

The utility of delegating with no limit may be calculated as a function of \( S \):

\[ U_C(S) = -x^2 = -S^2 \]

Thus, the center will only interfere and impose a policy limit if:
A.2 Model Form 2: Buying Policies with a Decentralization Decision

**Subnational Decision-Making:** If subnational leaders are given the chance to set policy, they will do so as described above: if the center does not offer compensation in return for policy, they will set policy at the subnational ideal point. If the center does offer compensation in return for policy, subnational leaders will choose to set policy at the policy limit, rather than the subnational ideal point only if the compensation offered by the center offers enough of a boost of utility to make up for the utility lost due to the policy outcome. This is the case when:

\[
(-\phi_c - \lambda^2) > -S^2
\]

\[
\phi_c + \lambda^2 < S^2
\]

\[
\phi_c < S^2 - \lambda^2
\]

and

\[
\lambda < \sqrt{S^2 - \phi_c}
\]

and

\[
S > \sqrt{\phi_c^2 + \lambda}
\]

**Central Decision-Making:** The center will choose to delegate decision-making but impose a policy limit if and only if the utility of delegating with a limit is greater
than both the utility of delegation with no limit and the expected utility of non-delegation, or if both of the following conditions are met:

$$U_C(\lambda, \phi_c) > U_C(S)$$

$$U_C(\lambda, \phi_c) > EU_C(\omega, \omega)$$

**Condition 1:**

We may evaluate each of these conditions in turn. First, the center will delegate only if the utility of delegating with a limit is greater than the utility of delegating with no limit, as shown above:

$$U_C(\lambda, \phi_c) > U_C(S)$$

The utility of delegating with no limit, as seen above, may be calculated as a function of $S$:

$$U_C(S) = -x^2$$

$$= -S^2$$

The utility of delegating while imposing a limit is a function of both $\lambda$ and $\phi_c$:

$$U_C(\lambda, \phi_c) = -\lambda^2 - \phi_c$$

Thus, condition one is met when:
\[
(-\phi_c - \lambda^2) > -S^2 \\
\phi_c + \lambda^2 < S^2 \\
\phi_c < S^2 - \lambda^2
\]

and

\[
\lambda < \sqrt{S^2 - \phi_c}
\]

and

\[
S > \sqrt{\phi_c^2 + \lambda}
\]

**Condition 2:**

In addition to the above limits on \(\phi_c\) and \(\lambda\), the center will only delegate if the utility of delegating with a limit is greater than the utility of simply not delegating at all, or if:

\[
U_C(\lambda, \phi_c) > EU_C(\omega, \omega)
\]

The utility of delegating with a limit is shown above to be:

\[
U_C(\lambda, \phi_c) = -\lambda^2 - \phi_c
\]

The expected utility of not delegating, which depends on the ultimate value of the random term \(\omega\) may be calculated based on the prior distribution of \(\omega\):
\[ EU_C(\omega, \omega) = \int_{-1}^{1} U_C(\omega) \, d\omega \]
\[ = \int_{-1}^{1} -\omega^2 \, d\omega \]
\[ = -\frac{2}{3} \]

Using the utility of delegation with a policy limit and the expected utility of non-delegation as determined here, condition two is met when:

\[-\lambda^2 - \phi_c > -\frac{2}{3} \]
\[ \phi_c < \frac{2}{3} - \lambda^2 \]
\[ \text{and} \]
\[ \lambda < \sqrt{\frac{2}{3} - \phi_c} \]

Thus, central leaders will prefer to retain policy-making authority only if subnational preferences diverge significantly from central preferences. For subnational ideal points that are close to the center’s ideal point, relative to the price of policy, central leaders prefer pure delegation, because the costs of compensation outweigh the advantages of the preferred policy outcome. For middle ranges of subnational ideal points, however (and particularly when the price of policy is low), central leaders will still choose to decentralize.
## Appendix B

### Included Country Years

<table>
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<tr>
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<tr>
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<tr>
<td>Albania</td>
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<tr>
<td>Brazil</td>
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<td>Bolivia</td>
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<td>Chile</td>
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Georgia 1997-2001; 2003-2008
Iceland 1995-1997
India 1995-2008
Indonesia 1995-1998
Iran 1999-2007
Israel 1995-1999
Jordan 2008
Kazakhstan 1997-2004
Latvia 1995-2008
Lesotho 2003-2008
Lithuania 1995-1999
Luxembourg 1999-1997
Macedonia 2006-2007
Malaysia 1995-2001
Malta 2002
Mexico 1995-2000
Moldova 1995-2008
Norway 1995-1999
Paraguay 2005-2008
Peru 1995-2008
Poland 1995-2000
Portugal 1996
Romania 1995-2001
Russia 1999-2001
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