

Combining Federalism and Democracy in Developing Countries

SUMMARY

This decade's geopolitical changes have given the governments of developing countries increased opportunities to shape their countries' future by designing appropriate institutions. Economic advisers today normally recommend these governments to strengthen

economic competition by abandoning planning systems and implementing markets. This, however, is no guarantee for a steady development. Competition must also be installed in the political realm in order to make the governments observe the preferences

of their citizens. Functional, Overlapping and Competing Jurisdictions (FOCJ) provide a system of dynamic federalism and democracy which breaks the monopoly of central government and shifts the power to local, functional and democratic units.

The breakdown of the Soviet Union and the Eastern Bloc has dramatically changed the economic and political prospects of large parts of the world. This is most obvious for the Eastern and Middle European countries, which aspire membership in the European Union, and which have more or less mimicked the institutions of their Western neighbours. But the seminal changes have also given the governments of developing countries increased opportunities to shape their countries' future by designing appropriate institutions. While most academic economists concentrate on the transition process in Europe, we focus on the problems of developing countries.

Economic advisers today normally recommend the governments of developing countries to strengthen economic competition by abandoning planning systems and implementing markets (Funke 1993). This, however, is no guarantee for a steady development: Many politicians misuse privatization programmes for their own purposes and form their own private monopolies, and future governments are not effectively prevented from reregulating the economy as long as the political institutions remain unchanged. Thus, competition must also be installed in the political realm in order to make the governments observe the preferences of their citizens. We argue that welfare can be improved substantially by promoting competition among newly emerging jurisdictions which are organized along functions in-

stead of territories, and which are established voluntarily by individuals or communes, to provide specific services to its members. These *functional, overlapping and competing jurisdictions* which will be called by their acronym *FOCJ* have four essential characteristics: they are

- *Functional (F)*, i.e. the new political units extend over areas defined by the tasks to be fulfilled;
- *Overlapping (O)*, i.e. in line with the many different tasks (functions) there are corresponding governmental units extending over different geographical areas;
- *Competing (C)*, i.e. individuals and/or communities may choose to which governmental unit they want to belong, and they have political rights to express their preferences directly via initiatives and referenda;
- *Jurisdictions (J)*, i.e. the units established are governmental, they have enforcement power and can, in particular, levy taxes.

FOCJ form a federal system of governments that is not dictated from above, but emerges from below as a response to citizens' preferences. Although our proposal proves to be highly suitable for the peculiar situation in developing countries, it was originally conceived for industrial economies (Frey and Eichenberger 1995, 1996) and in particular for the integration of Europe. Thus, many of our insights also apply to the more industrialized transition countries.

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The rest of the paper is organized as follows: Section 1 sketches out some typical aspects of the interdependence between politics and the economy in developing countries. Section 2 presents the basic idea of FOCJ for developing countries and section 3 discusses possible counterarguments. The question of how FOCJ can be established is briefly dealt with in section 4 and section 5 offers concluding remarks.

1. "Over-government" vs. "under-government"

Many developing countries are plagued by the problem of "over-government": Economic growth is hampered by excessive government interventions; the state tends to interfere in almost all activities and endeavours to regulate them minutely; the government sector which is often very large, employs a high proportion of the population outside agriculture; and the administration tends to be more bureaucratic than in industrial countries. In addition, rent-seeking distortions are rampant (e.g., public officials often receive much higher incomes relative to other occupations) and waste is pervasive. Many public employees do not really work in a productive sense, and some rarely show up for work. This combination of interventionism and bureaucracy stifles investment and innovation in the private sector (see e.g. Ostrom 1990, Krueger 1992).

In other respects, however, the same countries are also taken by some sort of "under-government". Governments do not adequately fulfil the functions necessary for rapid economic growth. Most importantly, they do not sufficiently secure the property rights which are needed for private economic activities. Investors are faced with a high degree of uncertainty, and are therefore reluctant to commit themselves over a longer run. Instead of concentrating on productive endeavours, investors are devoting their time and money to finding substitutes for the deficient property rights.

Governments in most third world countries are inadequate in a second, quite different sense. They are far from meeting the wishes of the citizens; many are either strongly paternalistic or even dictatorial. Changes in government rarely consider the preferences of the ordinary citizens. Rather, they merely substitute one group of the reigning elite or military with another. While the preferences of the city dwellers - in particular of the capital - are at least taken into account as far as to evade an uprising, the preferences of the population living in the countryside are almost totally disregarded. While some third world countries are officially federal, central governments are distanced from the fragmented local problems and demands, and consequently neglect them (e.g. de Valk and Wek-

wete 1990). Often, central government interference actively destroys traditional, well-working production and distribution arrangements, in particular self-governing units (Ostrom 1990, pp. 159-64; 1994).

Developing countries are thus faced with a paradoxical situation: at the same time there is "under-government" (too few governments caring for the fragmented local problems) and "over-government" (i.e. interventionism which hinders economic progress). The concept of FOCJ represents a proposal designed to solve this paradox. It constitutes a new and extreme type of *federalism* which allows for a much larger number of governments. The proposed units are based on grass-root local *democracy* which checks government and prevents it from evolving into an oppressive and intervening bureaucracy. Our proposal is radical as it deviates strongly from developing plans. It is worth observing that a large part of the economic literature on development does not deal with the structure of government. The failures of government are duly noted, but proposals of overcoming the lacuna are rarely advanced. To just hope that the future will bring "better politicians" is unfounded optimism. As Modern Political Economy (Public Choice, see e.g. Mueller 1989, or Frey and Eichenberger 1994 specifically for countries of the third world) has convincingly shown, politicians are not "bad" (or "good") as such, but it is the political institutions which make them, or allow them to behave in a particular way. Government will only improve if the underlying institutional conditions are changed. This is exactly the aim of our proposal: we advocate a system of government in which the basic units are defined by the various functions which the state has to fulfil to enable development. These jurisdictions are formed according to the "geography of problems", i.e. by the citizens seeking to cope with issues they are confronted with. The new type of federalism we envisage - unlike most existing federal units - is not imposed from above (sometimes by the former colonial powers) but forms from below.

2. FOCJ: The basic idea

To establish a system of FOCJ in developing countries constitutes a radical form of federal decentralization, and at the same time democratization. FOCJ have four major characteristics:

- (1) They are *functional*. Each political unit extends over areas defined by the task to be fulfilled. Such functional units may provide particular communal services such as fresh water and the treatment of waste water, electricity, gas and telephone; roads; and police protection and defence. In addition to these "modern" functional units, the long-established tribal borders are conserved as they care for particular servic-

es and needs (see Klitgaard 1995). Functional units allow for the economies of scale to be exploited, and for benefits and costs to fully match in order to minimize spillovers. They thus conform to the requirement of "fiscal equivalence" as developed by Olson (1969) and Oates (1972). As a result, the different units are able to cater for differences in local demands.

- (2) They are *overlapping*. In line with the diverse tasks, there are many different governmental units spanning geographical areas of varying sizes. Many of the functions mentioned above can be efficiently provided at the local, communal level (e.g. water, police protection, education, and a large share of medical services) while others extend over a wider geographical area (e.g. overland roads, electricity). A few should be in the realm of the national government, most importantly the guarantee of free mobility and free trade, as well as national defence. However, the bulk of the public activities is provided at lowest cost at the communal level. Small size governmental jurisdictions are also best able to meet the preferences of the citizens. Due to differences in geographical conditions, resource availability, economic activities, as well as the composition of the population with respect to income, occupation, age, race and religion, their demands for publicly provided services may differ widely. In the case of larger cities, the bulk of public services may be provided most efficiently at the level of wards or even blocks.
- (3) They are *competing*. Two mechanisms serve to induce the FOCJ to conform closely to their members' preferences. (a) The possibility to leave or enter a particular FOCUS (as we call the singular of FOCJ) mimics market competition; and (b) The use of democratic voting establishes political competition. The following paragraphs look at these mechanisms more thoroughly.
- (a) Exit may not only be undertaken by individuals or firms by migrating but also by political units such as blocks, wards or communes. They can change the FOCUS to which they belong for particular services if they feel that another FOCUS is providing better services at lower costs. In some cases, it is even possible for individuals to switch FOCJ without changing the physical location. Parents, for example, may send their children to a particular public school which they consider to be the best and most suitable.

The freedom to exit is a powerful force restricting government, and in particular the central state (see recently Weingast 1995). It stands in stark contrast to the prohibition of secession characterizing na-

tional states. The fight against secession has led to bloody and self-destructing wars, e.g., in Katanga (1960-63), Biafra (1967-70), Bangladesh (1970-71), and over the last years, in Yugoslavia and Russia. The type of exit envisaged here differs crucially from these kinds of secession. The switch from one FOCUS to another FOCUS (e.g. from one provider of school services to another) is a very *partial* exit only; all other governmental functions remain unaffected. Some citizens of a national state may, for example, form their own units with respect to education (where they specially promote their own language) or with respect to trade laws (they choose the one which best suits the requirements of their business activities). With respect to religion, such diverse units already exist in many countries, and switching from one religious denomination to another is frequently observed. All this is possible without breaking away from the national state. It would, however, be advantageous if such jurisdictions were not just limited to a state but may also extend to other states. There is no reason why, for instance, a FOCUS providing educational or religious services should not cover parts of several nations. The possibility to exit only partially in contrast to being forced to an all-or-none choice of secession is a particularly appealing feature of FOCJ.

When partially leaving a traditional governmental unit and entering a FOCUS, the respective citizens' tax burden has to be rebalanced. While they have to pay taxes in the new FOCUS to finance the particular services provided, they should get an appropriate tax discount in the unit they partially leave. Moreover, there are circumstances under which efficiency can be increased by allowing the present members of a FOCUS to levy a price for entry and exit. When an individual leaves, jurisdictions may charge a fee equal to the marginal cost of the public services privately appropriated. This is of particular importance in the case of higher education. On entering, one may have to pay a fee in order to share the use of the infrastructure accumulated and financed by the present members. It is one of the major functions of the central government to secure competition by preventing FOCJ from charging monopolistic entrance and exit prices.

(b) Political competition is effected via democratic institutions. The citizens directly elect the persons managing a particular FOCUS, and they can participate in decision-making about substantive issues by undertaking popular initiatives and referenda (i.e. using the voice option; see Frey 1994). Wherever possible, the traditional forms of direct democracy should be employed, such as assemblies of all citizens concerned. A system of FOCJ allows to maintain the historically grown governance structures, and fosters their variety.

(4) FOCJ are *jurisdictions*. A FOCUS is a democratic governmental unit with authority over its citizens. Most importantly, it has the power to tax for the services provided. In FOCJ, taxes are not an oppressive means of financing unknown activities of far away governments but have the character of charging fees for well-defined, particular services. Individuals and communes can newly establish a jurisdiction, when they feel they are more capable of supplying a public good, or doing so at lower costs.

As is true for all other forms of federalism, the power to tax is an essential ingredient of FOCJ. Whenever the central government allocates the funds (as it is the rule in today's "federal" developing countries, Oates 1993) the lower level units become dependent on it, so that most of the advantages of decentralization are lost. Under these circumstances, decentralization is not necessarily beneficial. In a system in which the finance is allocated by the centre, the lower units have an incentive to become fiscally irresponsible. Local authorities tend to borrow too much on the (normally correct) assumption that they will be bailed out by central government if they run into trouble. In Brazil, say, the Sao Paulo region has accumulated a debt of \$40 billion, over 7% of the country's GDP (see more generally, Tanzi 1995). In contrast, if FOCJ have the power to levy their own taxes, the population would have to carry the cost of bad politics. Therefore, the governments have an incentive to observe the budget constraint and to behave in a fiscally responsible way.

These four characteristics of FOCJ produce major advantages over the existing form of government in developing countries:

- (i) They break the central government's virtual monopoly of politics which would otherwise stifle economic development and oppress the citizens. FOCJ shift the political power to initiatives from below. Effective local governments become viable because they have authority over a particular government function, and may raise taxes to finance the respective expenditures.
- (ii) FOCJ allow combinations of various forms of political rules. They do not only blend federalism and democracy, i.e. exit and voice, but also modern and traditional styles of governing such as meetings by village elders. Time-proven local ways of public decision-making are not dumped but are used and fostered in those areas in which they prove to be effective.

(iii) FOCJ solve the "fundamental organizational dilemma" between an open polity and decentralized development at the local level: "...one of the necessary (though far from sufficient) conditions of a development state [is] a large degree of insulation that the development-minded decision-makers can have against the ravages of short-run pork-barrel politics and their ability to use the discipline of the market (...) against the inevitable follies of group predation" (Bhardan 1993, p. 46). This insulation is made possible in a system of FOCJ by the establishment of new, growth-oriented government units which are, however, disciplined by economic and political competition.

(iv) FOCJ deal with another "fundamental dilemma of government" (Montignola, Qian and Weingast 1995, pp. 54-5). The state has to be strong enough to enforce the legal rules and especially the property rights which are prerequisites for economic development. At the same time, government institutions have to be "weak" in the sense of not exploiting the citizens, e.g., by expropriating them without compensation or taxing them excessively. FOCJ are able to convey credible limits against such exploitation because each FOCUS is self-financed and may go bankrupt, thus imposing a hard budget constraint. In a system of FOCJ, individuals and firms do not face a monopolistic and therefore oppressive state, but may resort to substitutes.

(v) There is an emphasis on local public production and efficient polycentric organization. This aspect has been much neglected in the literature¹.

(vi) The fiscal decentralization induced by FOCJ reduces the volatility in macroeconomic variables (e.g., in budget deficits, inflation, income growth), as the government is more closely bound to the citizens' preferences. Moreover, decentralization (and the concomitant sequencing of the elections at the various governmental levels) reduces the governments' incentives and their potential to produce political business cycles (Simon, Ostrom and Marra 1991).

The concept of FOCJ overcomes the fruitless contradiction of "government versus market" which was typical of many of the writings on developing countries (see Klitgaard 1991, Ostrom 1990). Rather, a third form of governance is enabled to play its role, the *self-government* of the persons directly involved in a particular public task.

¹ "Little attention has been paid [in the literature] to the efficiency of local government expenditure in developing countries", Rondinelli, McCulloch and Johnson (1989, p. 71); Ostrom, Schroeder and Wynne (1993), p. 210.

3. Assessing the critique

FOCJ mark a radical departure from much of the earlier literature on developing countries which emphasized the need for a strong, well-organized central state and bureaucracy to steer and support economic growth. They depart from the more recent exclusive emphasis on private property and free markets as the clue for successful development. In both cases, local governments needed for economic growth are neglected. Some readers may, however, think that the advantages of FOCJ as claimed are much too optimistic, and that the proposal is just naive. We present here five assertions which are often brought up, but which we will refute:

Assertion 1: FOCJ have never existed

This historical critique is factually incorrect. The pre-colonial political system in developing countries was characterized by various forms of self-government (e.g. Manglapres 1987) though they, of course, did not meet the criteria of democracy which we are familiar with. Vestiges remain even today, but this traditional way of governing was on the whole destroyed by the authoritarian colonial rule (e.g. Chazan 1994, Oates 1993, Oberreuter and Weiland 1994). Post-colonial governments wanted to centralize as much power as possible in their hands and consequently destroyed traditional local rule (see Diamond 1994, Oates 1993, Ostrom 1990).

Assertion 2: FOCJ are unsuitable for developing countries

The "culturalist position" (e.g. Booth and Seligman 1994) maintains that individuals in developing regions are basically different from Westerners, and therefore need a different form of government, arguably a more authoritarian one. A popular version of this belief is that people in third world countries lack the discipline and initiative to form FOCJ. The economic approach to human behaviour (Becker 1976, Frey 1992) suggests the opposite causation. The lack of discipline and initiative observed is the *consequence* (and not the cause) of unfavourable institutional settings. Three types of empirical observations strongly support the economic view:

- (i) When individuals in developing countries shed the stifling restrictions imposed upon them by government bureaucracies, they become active and venturesome. Thus, de Soto (1989) has shown for Peru that people who are passive within the confines of the highly regulated and inimical official sector become enterprising and energetic once they act in the unofficial or shadow economy. This observation does not only apply to Peru but also to all developing countries as casual observation

(e.g., the dramatic changes in Asia) and scientific research show. Indeed, the unofficial economy is extremely lively but has, of course, limits. The people who are active in it evade taxes and disregard public regulations, and become independent. Such an emancipation of the population from the (central) government is dangerous for the political class because it demonstrates that this is not needed, at least for some purposes. As a consequence, existing governments make strong efforts to clamp down on the unofficial economy (but, fortunately, often with little success). In contrast, FOCJ constitute a means to reintegrate the shadow sector into the official economy without destroying its vigour.

- (ii) Empirical evidence shows that to the extent self-governance could be preserved, it often functions well and is even able to solve difficult common property resource problems (Ostrom 1990, Ostrom et al. 1993, Wade 1988).
- (iii) Even experiences with an extreme form of democracy, popular referenda, are positive - provided they are devoted to substantive issues and not simply plebiscites to support the authoritarian or dictatorial rulers (Rourke, Hines and Zirakzadeh 1992). If they are taken seriously, people in developing countries do participate in political affairs (for Africa, e.g., Chazan 1994; for Mexico, see Oberreuter and Weiland 1994).

Assertion 3: FOCJ worsen inequality

Many people believe that central governments promote equality while federal systems make the rich richer and the poor poorer. Central governments are at best *formally* committed to an "equal" provision of public services but in actual fact, there are huge differences in the services provided across the country (Ostrom et al. 1993, p.211, speak of a "myth of equality"). Typically, the population in the capital is grossly favoured, in particular by highly subsidized food, while the much poorer inhabitants in the rural areas are taxed (Bates 1988). FOCJ redress such imbalances because they are based on decentralized decision-making and subsequently allow regional and local development of the natural and human resources available.

Assertion 4: FOCJ are uncoordinated and create spillover

This argument is unfounded because FOCJ are established precisely to minimize spill-overs as they extend over the relevant functional areas. It could at best be argued that there are spillovers *between* FOCJ. However, the same problem exists within unitary centralized governments where co-operation between various state agencies is difficult, but not impossible to achieve. FOCJ coordi-

nate their activities in a similar way as do state agencies, namely by exchanging information and by bargaining.

Assertion 5: FOCJ are not new

There is virtually nothing new under the sun; this also applies to the idea of establishing functional, overlapping, and competing jurisdictions. A similar concept has been suggested by Burnheim (1985) but he has not worked it out, and has linked it to rather wild ideas on property rights in land and capital. Tullock (1994) is another forerunner. He observes that in the United States there are functional units which care for particular public services, and which are formed and controlled by particular groups of citizens. Neither Burnheim nor Tullock relate their observations to the various governmental units, such as the American "special districts" (see Zax 1988), to the "Zweckverbände" existing in German-speaking countries, or to the multiple, overlapping communes in Switzerland (see Frey and Eichenberger 1995). Moreover, even old ideas can be useful. What matters is whether an idea can become important in the current intellectual debate, and can be applied in reality. On both accounts, FOCJ seem to be worth expounding. The importance of the dynamic form of federalism proposed by us is certainly not common currency. Two recent authoritative politico-economic works on developing countries (Krueger 1992, Bates 1988) do not even once mention the concepts of "federalism", "devolution", "decentralization" or "direct democracy".

4. How can FOCJ emerge?

FOCJ are not established by government fiat; they arise endogenously from below if the population considers them to be advantageous. The only, but crucial, conditions are that (i) the constitution allows the establishment of FOCJ, (ii) existing and newly-founded FOCJ are tolerated by higher level governments and bureaucracies, and (iii) the citizens forming a new FOCUS have to get an appropriate tax discount in the governmental unit they partially leave. Many third world nations, particularly in South America, are focussed on a legalist and constructivist concept of institutions which makes it difficult to allow for spontaneously emerging jurisdictions. Even more difficult to reach are the second and the third conditions. The professional politicians both in and out of government, comprising typically the established élite, put up fierce resistance to FOCJ because they would necessarily lose part of their power. The emergence of FOCJ would indeed basically change politics in developing countries. This resistance is difficult to overcome but development aid by the World Bank and donor nations could be used to circumvent established political élites as much as possible, and to favour local self-government in the form of FOCJ.

5. Conclusions

Functional, Overlapping and Competing Jurisdictions (FOCJ) provide a useful system of dynamic federalism and democracy that is able to solve some of the major problems of economic and social development in third world countries. In particular, it breaks the monopoly of central government and shifts the power to local, functional and democratic units. The concept of FOCJ offers a new and promising perspective to cope with ethnic tensions and minority problems. As it institutionalizes opportunities of partial exit, it seems much more favourable compared to the present political reality where exit is mostly an "all-or-nothing" choice which often ends in civil war.

However, the concept of FOCJ is not just restricted to developing countries. It is applicable to any country where the constitutional process is in a state of flux. This is particularly valid for the European integration. While it seems impossible to integrate the Eastern European countries in the current structures of the European Union with its huge redistribution programmes, FOCJ constitute an elegant way of integrating the Eastern European countries along functions. Another application of FOCJ is the federalization and decentralization of the transformation countries themselves. It is well possible that in countries like, e.g., Russia or Bosnia, FOCJ offer a better solution to the pressing problems than today's political proposals which are imposed from above and which are subject to the constructivist fallacy.

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