The Economic Role of Political Institutions: Market-Preserving Federalism and Economic Development

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Thriving markets require not only an appropriately designed economic system, but a secure political foundation that limits the ability of the state to confiscate wealth. This requires a form of *limited government*, that is, political institutions that credibly commit the state to honor economic and political rights. This article studies how limited government arose in the developed West, focusing on the critical role of federalism for protecting markets in both England and the United States. Federalism proved fundamental to the impressive economic rise of England in the 18th century and the United States in the 19th and early 20th centuries. The article also shows that federalism underpins the spectacular economic growth in China over the past 15 years.

Introduction

The fundamental political dilemma of an economic system is this: A government strong enough to protect property rights and enforce contracts is also strong enough to confiscate the wealth of its citizens. Thriving markets require not only the appropriate system of property rights and a law of contracts, but a secure political foundation that limits the ability of the state to confiscate wealth. Far from obvious, however, are the circumstances that produce a political system that plays one role instead of the other.

This dilemma is readily apparent for the case of economic reform in Eastern Europe and the former Soviet Union. Economists focus on providing for the broad outlines of a market system, that is, on "getting prices right." Unfortu-

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nately, the economists' focus ignores politics and the possibility that political forces might intervene in the future to halt the development of a market system or to redistribute a large portion of the wealth thus created. Not only do political forces hold the potential to destroy a fragile, nascent economic system, but their prospect deters the economic activity necessary for economic growth. As economists have long realized, the absence of secure protection for the reward to effort deters investment and, hence, economic development (Eggertson, 1990; North, 1981, 1990; Olson, 1982; Williamson, 1994).

The fundamental political dilemma forces us to ask what form of political system is required so that a viable, private market economy is a stable policy choice of that political system? The answer concerns the design of political institutions that *credibly commit* the state to preserving markets, that is, to limits on the future political discretion with respect to the economy that are in the interests of political officials to observe (Levy and Spiller, 1994; North, 1993; Weingast, 1994a, 1994b; Williamson, 1994). The central component of a credible commitment to limited government is that these limits must be self-enforcing. For limits on government to be sustained, political officials must have an incentive to abide by them. This implies that designers of economic reform must pay attention not only to the reform's content but to how the future exercise of political discretion might alter that policy.

In the language of the new institutional economics, providing a secure and predictable political foundation for the markets requires a form of *governance structure* (Williamson, 1985, 1994; Weingast, 1993b).[1] To understand the political foundations of markets, we must begin with the *constitution*, conceived here as the set of institutions governing political decision-making—that is, the institutions or rules governing how policy choices are made, especially among alternative specifications of the economic system. All societies possess a constitution in this sense, whether or not they possess an explicit document called "the constitution."[2] For example, Roeder (1993) describes the operation of the working constitution of the former Soviet Union, as opposed to its nominal, written constitution. Understanding the relationships between constitutional provisions and economic performance requires development of a new *positive theory of constitutionalism* that seeks to explain how constitutional limits work and why some constraints prove binding in practice.[3]

1. Notice that this logic directly parallels that in the theory of the firm. Williamson (1985: 48-49), for example, argues that when transactions are subject to ex post problems, wise bargaining parties will attempt to mitigate these problems ex ante by creating a *governance structure*. See Milgrom and Roberts (1992) for a recent and comprehensive statement of the theory.

2. Nor does this require that the constitution contain provisions supporting democracy, representation, or secure political and private rights for individuals, though most Western constitutions do so. Constitutions in the developed West are thus an important special case of constitutions. In contrast to the more general range of constitutions, those in the West possess a range of additional (and generally thought to be desirable) attributes.

3. Recent work includes Hardin (1989), North and Weingast (1989), Ordeshook (1993), Ordeshook and Schwartz (1994), Przeworski (1990), Riker (1982), and Weingast (1994a); see also

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One of the central limits of the literature is that few scholars actually provide a complete analysis of any mechanism purported to provide such credible commitments (an important exception is Levy and Spiller, 1994). We remain remarkably ignorant about how constitutions affect credible commitments to secure economic rights and, more generally, limited government.

To learn something about how constitutions credibly commit a state to markets, this article considers how such commitments were provided in the developing West over the past few centuries. Because many of the crucial questions facing today's developing states were once faced by developed nations, considerable insight can be provided about today's problems by studying similar problems as they arose in the past. Although today's circumstances differ substantially from those of earlier eras, important lessons about the political foundations of markets can still be learned.

For this purpose, I focus on federalism, an important mechanism underpinning development in many nations. For most of the last 300 years, the richest nation in the world has had a federal structure: the Netherlands from the late 16th through mid-17th century, England from the late 17th or early 18th through the mid-19th century, and the United States from the late 19th century until the late 20th century. A specific form of federalism, here called *market-preserving federalism*, limited the degree to which each of these country's political systems could encroach upon its markets.

The economic consequences of market-preserving federalism are well-known: Federalism restricts economic policymaking via limits on the discretion of the government (Tiebout, 1956; Oates, 1972). Less well understood is the central problem of this article: how a system of federalism provides for its own survival. If federalism has strong, binding effects, what makes its restrictions self-enforcing? Specifically, what prevents interest groups and distributional coalitions, limited in their influence over lower-level governments, from pressing the central government to break the restrictions of federalism and intervene in the economy (Riker, 1964)? The answer cannot be simply a written rule, for rules can be changed, avoided, or ignored. To survive, federalism requires self-enforcing restrictions, ones that make it in the interests of national political actors to honor them. The purpose of this article is to show how these mechanisms work in three contexts where federalism has underpinned rapid economic development: England during the 18th century, the United States during the 19th century, and modern China. In so doing, the article provides some general principles of a society's constitutional order that are necessary to provide secure political foundations for markets.

The article is divided into three parts. Part 1 contains two sections that focus on the effects of federalism and puts these in a political perspective. Section 1.1 describes the political theory of market-preserving federalism, and Section 1.2 discusses its role in the economic development of England and the United

Elster (1991), Hammond and Miller (1989), North (1981, 1990). Much of Brennan and Buchanan's (1984) work is also included, though much of it is also normative in character.

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States. Part 2 focuses on the deeper question of what made federalism and its restrictions credible. Section 2.1 analyzes how federalism was sustained in England, and Section 2.2 does so for the United States. Part 3 turns to contemporary settings of economic reform in the former communist states, focusing on economic reform in China. My conclusions follow.

1. The Effects of Federalism

1.1 A Political Theory of Federalism

The essence of federalism is that it provides a sustainable system of political decentralization. Although the political theory of federalism has a long history, it is useful to start with Riker.[4] In his seminal work on the political theory of federalism, Riker (1964: 11) defines a political system as federal if it has two characteristics: (F1) a *hierarchy* of governments, that is, at least "two levels of governments rule the same land and people," each with a *delineated scope of authority* so that each level of government is autonomous in its own, well-defined sphere of political authority; and (F2) the *autonomy* of each government is institutionalized in a manner that makes federalism's restrictions self-enforcing.

In what follows, I focus on a subset of federal systems called *market-preserving federalism* (see also McKinnon, 1994; and Montinola, Qian, and Weingast, 1995). A federal system is market-preserving if it has three additional characteristics: (F3) subnational governments have primary regulatory *responsibility over the economy*; (F4) a *common market* is ensured, preventing the lower governments from using their regulatory authority to erect trade barriers against the goods and services from other political units; and (F5) the lower governments face a *hard budget constraint*, that is, they have neither the ability to print money nor access to unlimited credit. This condition is not met if the central government bails out the lower one whenever the latter faces fiscal problems (McKinnon, 1994).

Each of these characteristics plays an important part in federalism's market-preserving role. The first is clearly a defining characteristic establishing minimal or necessary conditions for a federal system. But it alone is not sufficient. The reason is that federal systems are not generally sustainable if they depend solely on the discretion of the highest political authority, because that delegation of power can always be reversed. As Riker observes, a central problem for federal systems is that the highest or central government may *overawe* the lower units. A sustainable system of federalism therefore must prevent the central government's ability to overawe the lower governments, as condition two requires.

The first two characteristics define a viable system of federalism, but they say nothing about the authority over economic issues. To have market-preserving

4. This section draws on the work of Aranson (1991), McKinnon (1994), Oates (1972), Riker (1964), and Tiebout (1956). See also Elazar (1987), Friedrich (1968), Hayek (1939), and Wheare (1953). Although most of the latter discuss many of the conditions that follow, sometimes implicitly, all omit the critical third condition about self-enforcement.

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economic effects, federalism must also have the third, fourth, and fifth characteristics. The central government's authority to make economic policy must be limited; this authority must be in the hands of the lower political units. Moreover, the local governments must face hard budget constraint. This constraint induces proper fiscal management (McKinnon, 1994). Were lower governments bailed out of fiscal problems, either by the central government or via access to printing money, they would have far less reason to worry about the fiscal consequences of their decisions.

Notice that some states will call themselves federal although they fail to meet the above five criteria, while others may not call themselves federal but do meet the criteria. Thus, as Williamson (1994) observes, there is a distinction between de facto and de jure federalism. This suggests that traditional approaches to federalism are based on formal or legal distinctions that are irrelevant for the questions studied here. In what follows, we study states that meet the above five criteria without regard to whether they call themselves federal.

1.1.1 Economic Consequences of Market-Preserving Federalism. The economic consequences of market-preserving federalism, explored by Hayek (1939, 1960) and made famous by Tiebout (1956), are sufficiently well-known that they need be described only briefly here.[5] The first and perhaps best studied effect is the induced competition among lower units of the federal structure. The restrictions on the central government's regulatory power combine with competition among lower jurisdictions to imply that no government has monopoly control over economic regulation. As long as capital and labor are mobile, market-preserving federalism constrains the lower units in their attempts to place political limits on economic activity, because resources will move to other jurisdictions.

The literature on the economic effects of federalism yields two principal conclusions about public policy choice. First, political competition implies that jurisdictions must compete for capital, labor, and economic activity by offering menus of public policies (e.g., levels of taxation, security of private rights, social amenities, and public goods). Economic actors make location decisions based in part on those menus. In combination, the choices of local jurisdictions and economic actors yield a diversity of public goods, with some jurisdictions providing lower taxes and a lower level of public goods and others providing higher taxes and a higher level of public goods.[6]

Second, competition implies that only those restrictions that citizens are willing to pay for will survive. Were a jurisdiction to respond to political pressure by attempting to cartelize an industry, the mobility of labor implies that it will relocate in more compatible jurisdictions. If a jurisdiction attempts to confiscate the wealth of an industry, the mobility of capital implies that firms

5. For recent results and surveys of this literature, see Aranson (1991), Casella and Frey (1992), Inman (1987), McKinnon (1994), Oates (1972), Rubinfeld (1987), and Scotchmer (1994).

6. Here too, qualifications to the general results have appeared; see Aranson (1991), Inman (1987), and Scotchmer (1994).

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will relocate. The mobility of resources thus raises the economic costs to those jurisdictions that might establish certain policies, and they will do so only if the political benefits are worth these and other costs.

Federalism thus greatly diminishes the level and pervasiveness of economic rent-seeking and the formation of distributional coalitions. Competition among the lower units limits the success from rent-seeking. Because such regulation qua rent-seeking can only be local, it provides firms outside that locale with a competition advantage over those being regulated. Nonetheless, when, in a given locale, individuals' willingness to pay is sufficient, local governments will provide a specific array of goods and services.

1.1.2 Sustaining Market-preserving Federalism. A principal feature of the economic analysis of federalism is that it takes federalism's division of political authority as given. In political terms, the economic analysis of federalism ignores how Riker's second characteristic F(2) is achieved. Although I postpone until Part 2 the discussion of how it is achieved in practice, the previous discussion demonstrates why it is necessary.

The beneficial economic consequences of federalism result from the political decentralization of economic authority that induces competition among the lower political units. Were the structure of political authority solely at the discretion of the central authorities, the beneficial effect could not be realized, because they would respond to the interests' appeals for intervention in precisely the same manner as if there were no federalism. Without a mechanism to prevent this action by the central level, market-preserving federalism would be neither sustainable nor market-preserving. Something must provide durability to the limits on the central government's authority to regulate directly, to usurp that authority, or simply to remove its earlier grant of that authority to the lower levels. In short, federalism's restrictions must be self-enforcing.

1.2 Market-preserving Federalism in Practice

This section surveys two systems characterized by market-preserving federalism: 18th-century England and the 19th-century United States.[7]

1.2.1 Federalism in England. Though the British do not use the label *federalism*, by the criteria given above, 18th-century England was a de facto federal system.[8] First, the national and local governments were important and distinct sources of political authority. Second, by the beginning of the 18th century, the

7. Though what follows focuses only on Anglo-American cases, similar arguments can be made for the role of federalism in the economic rise of Switzerland and Germany.

8. The reason England was not a de jure system of federalism is that 18th-century England did not possess political jurisdictions such as states, cantons, or *länder* that are associated with governments typically labeled as federal. Nonetheless, despite the absence of states or *länder*, 18th-century England fits the five criteria given above. As we show below, various local governments had considerable political and economic freedom over the economy.

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national government was limited in its ability to regulate the domestic economy (though international trade was heavily controlled). The constitutional changes during the 17th century abolished, greatly restricted, or granted jointly to Parliament and the Crown many of the powers used by the deposed Stuart kings. Throughout the Stuarts' reign, rent-seeking activity was prevalent (Ekelund and Tollison, 1981), and many of these constitutional changes were aimed at preventing it.

From the standpoint of this article, England's market-preserving federal structure proved critical to the industrial revolution. The importance of the induced competition among localities is revealed by its effects on the pattern of local economic controls. In nearly all the established commercial centers of England, production was controlled via local regulatory laws. Various industries and professions, for example, were governed by guilds, whose regulatory controls attempted to limit competition, pricing, entry, and training. These constraints handicapped potential entrants, including those attempting to devise new forms of economic activity or to promote significant innovation for existing activities.

Two interrelated aspects of the industrial revolution concern us. First, economic historians emphasize that one of the central factors underlying the industrial revolution was the absence of enforcement of these restrictions (see, e.g., Mokyr, 1988). Second, that absence was neither uniform nor accidental (see Hartwell, 1971; and esp. North, 1981: chap. 12). And it is important from our perspective that the absence of restrictions reflected local political policy choices. As is well-known, industrialization did not proceed in the established commercial centers, but instead in the north. One of the foremost scholars of the industrial revolution, T. S. Ashton, concluded that the absence of regulatory restrictions was decisive for location decisions:

> It is beyond doubt that employers often transferred their activities from corporate towns in order to escape from restrictions imposed by privileged groups of workers, or from municipal regulations as to labour ... [T]he movement of industry was rarely induced by the prospect of lower wages in the new area. (Ashton, 1955: 94)

Trying to evade local economic restrictions, many of the new entrepreneurs who were so critical to the industrial revolution located in areas traditionally outside the commercial orbit.

Root's (1994) comparison of England and France reveals an important difference in the legal response to the locational decisions of new enterprises. In England, Parliament and many local Justices of the Peace (JPs) refused to extend guild restrictions and jurisdiction to the countryside. Typically selected from the local gentry, JPs were unpaid and owed only nominal allegiance to the crown, particularly after the Glorious Revolution (1688–89). Local JPs cared far more about local prosperity—often their own—than about implementing policies for the benefit of those outside their jurisdiction. "By contrast, the French royal courts supported the claims of French guilds to regulate rural production,"

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thus hindering rather than fostering industrial development in France (Root, in press: chap. 5).[9]

Two aspects of England's market-preserving federalism fostered economic growth during the industrial revolution. First, limits on the national government's authority to regulate economic activity prevented it from responding to efforts by the established economic interests to provide national controls that would have effectively prevented many of the new industrial activities.[10] Second, the induced political competition among local jurisdictions implied that some localities were willing to take on the extra burdens in exchange for the prospect of generating new forms of economic activity, local employment, and taxes. The absence of local political freedom would have significantly hindered the industrial revolution. Federalism thus provided a necessary and decisive *political* foundation for England's industrial revolution.

1.2.2 Federalism in the United States. At its inception, the United States Constitution granted the states the power to provide their citizens with various forms of public goods. The historical record shows that they took advantage of these powers in different ways (Handlin and Handlin, 1947; Hartz, 1948; Hughes, 1977). The Constitution also allowed states to respond to interest groups and distributional coalitions, but limited the reach of each state's policies to its own territory. Federalism provided strong limits on the degree to which these coalitions could impose uniform national regulations.

The commerce clause provided one of the Constitution's central pillars in its protection of markets (for a discussion of this issue, see Aranson, 1991).[11] This clause prevented states from regulating interstate markets and from erecting various forms of trade barriers. It also limited federal regulation to problems truly national in scope, an authority not exercised via direct intervention in domestic markets for the first 100 years of the Constitution. As Hayek (1960: chap. 12) observed, federalism thus proved the solution to the dilemma of how to limit the states' protectionist activities without providing the national government with too much power.

The consequence was one of the largest common markets in the world, one with strong protection of property rights and an absence of economic regulation. The constitutional limits on state and federal governments provided the critical political foundation for the enormous expansion of the economy during the 19th century. By mid-century, the pattern of interregional trade had transformed the

9. These conclusions are shared by a range of scholars. Landes (1969: 18–19), for example, emphasizes that "a crucial element in the rise of industrial capitalism [was] the spread of commercial manufacture from the towns to the countryside ... [Yet] the very unevenness of this development ... is testimony to the fierce and successful opposition it encountered from privileged interests in the towns."

10. Indeed, the Stuarts' inclination toward this form of regulation, paralleling similar inclinations in absolutist France, underpinned one group of the domestic opposition to them during the Civil War in the 1640s and the Glorious Revolution in the late 1680s.

11. The commerce clause was by no means the sole clause designed for this purpose; another example is the privileges and immunities clause.

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nation from one of largely self-sufficient farmers at the time of the Constitution to one of striking regional—and international—economic specialization (North, 1961; Fogel, 1989). The growth in national wealth reflected this pattern of specialization.

In broad outline, the South specialized in the production of cotton and other exports. During the early part of the century, strong and growing international demand for cotton helped fuel American economic growth (North, 1961; Lee and Passell, 1979). The Northeast specialized in providing commercial services, for example, transporting cotton to European markets. It also provided insurance, marketing, and other financial services attending the growth and delivery of these exports. The Northwest, largely self-sufficient at first, increasingly came to specialize in growing food. These crops were shipped south along the water routes and, increasingly, east via canals and railroads. On the eve of the Civil War, a large portion of Midwestern farmers were specialists in international markets, producing grain bound for Europe (Bogue, 1963; Fogel, 1989). Except for the interruption of the Civil War (including its lasting deleterious effects on the South), this process of growth and specialization continued throughout the century. By century's end, the United States was the richest nation in the world.

The relatively unregulated aspect of the thriving markets of the 19th century is so taken for granted by modern economic historians that it is not analyzed in any detail (see, e.g., Lee and Passell, 1979; or Fogel, 1989: Part 1; an important exception is Temin, 1991). Neoclassical economics, taking property rights as given, accepts secure economic rights in the 19th century without analysis. And yet the absence of federal intervention to alter markets and property rights was neither inevitable nor due to lack of demand. Just as today we observe a host of displaced economic interests providing political support for intervention to halt or reverse the changes accompanying economic growth, so too did groups in the 19th century. Thus commercial agents along the traditional water transportation routes fought the growth of the railroads. Cattle producers in upstate New York sought relief from cheaper producers farther west. Nascent manufacturers in the Northeast fought cheap land policy at the federal level because lower prices increased immigration rates. Although the reasons varied from case to case, these interests were by and large unsuccessful in their attempts to gain beneficial legislation.[12]

The absence of debilitating regulatory intervention critically depended on the common market's secure political foundation limiting the ability of state and federal governments to respond to distributional coalitions. For well over a century, domestic, interregional markets were not only unregulated but *protected from regulation* by the Constitution's constraints. As emphasized above, federalism was central to these constraints.

12. See Miller (1971) on the railroads and Passell and Schmundt (1971) on Northeastern interests and immigration policy. More generally, see Chandler's (1977) systematic study of industrial change in the second half of the 19th century.

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2. Credible Commitment to Federalism

Part 2 discusses the principal constitutional mechanisms that underpinned federalism in England and the United States, focusing on what made federalism self-enforcing.

2.1 Self-Enforcing Market-preserving Federalism and the Rule of Law in 17th- and 18th-Century England

The task of this section is twofold: to develop a model of a constitutional consensus about the limits on governmental action and to apply it to help explain the absence of economic intervention in 18th-century England.

The question we study concerns the limits on sovereign or state power. Why are institutional constraints on government observed? In particular, given the omnipresent temptations to avoid, break, ignore, or end-run these restrictions, what preserves limited government? One approach concerns the notion of *legitimacy*: A regime finds it difficult to violate provisions of a constitution that its citizens feel are legitimate. Although promising, this approach is fraught with problems: What determines when a constitution is legitimate? Can this notion be operationalized so that it is not tautological? And how does legitimacy translate into the preservation of a specific constraint on government?

The purpose of this section is to develop an approach to the problem of legitimacy in a way that answers these questions.[13] To make sense of this concept, we begin with individual citizens. To avoid tautology, we root legitimacy in individual citizens, not in the society. We assume that each citizen holds a specific view about the appropriate bounds on governmental action.

Defined in this way, the problem of legitimacy creates two enormous social problems. The first arises because in and of itself, nothing brings citizens to a uniform view. Indeed, economic, political, and social differences work to differentiate their notions of what actions are legitimate. In the language of game theory, the problematic nature of citizen agreement on the appropriate bounds of government creates a *coordination* problem.

The second problem concerns the relationship between a citizen's views about the appropriate bounds on government and what happens when those bounds are violated. Put simply, even if all the citizens agree on the appropriate bounds of government, what keeps the government from ignoring those bounds?

The importance of these two problems arises because they hold the key to the success of limited government. Constraints can be policed only when citizens react in concert against the government's violations. Success requires the conjunction of two aspects of citizen behavior: First, citizens must react to violations by punishing the government; and second, they must hold sufficiently similar views about the appropriate bounds on government that they react in concert when the government oversteps those bounds. In the language of game theory, we are searching for an equilibrium to a game in which the government has the opportunity to violate constraints but chooses not to do so.

13. What follows summarizes the model and results presented in Weingast (1994b).

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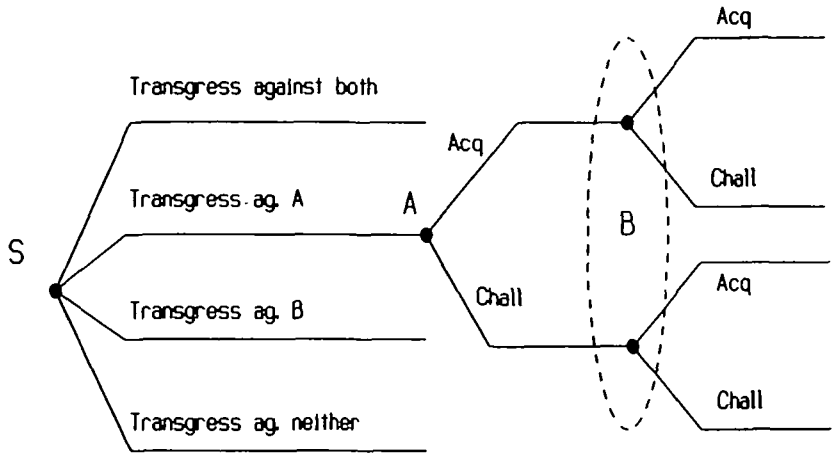

Figure 1. The sovereign-constituency transgression game (Acq = to acquiesce to a transgression, Chall = to challenge it).

The model is based on two assumptions about the relationship between a sovereign and his or her citizens. First, a necessary condition for an individual citizen to support the sovereign is that the sovereign not transgress that citizen's rights. Second, remaining in power requires that the sovereign retain a sufficient degree of support among the citizenry. Without the necessary support, the sovereign loses power.

2.1.1 The Model We suppose there is a single sovereign, S, and two groups of citizens, A and B. The groups of citizens have different views about the legitimate boundaries of the state and hence what actions by the sovereign are considered a fundamental violation of their rights. In this game, the sovereign needs the support of at least one of the two groups in order to retain power.

The sequence of actions in this game is shown in Figure 1. S moves first and may choose to attempt to transgress against both A and B, against A alone, against B alone, or against neither. After S moves, A and B move simultaneously.[14] Each may choose to acquiesce or to challenge the sovereign. Challenging is costly; moreover, each may challenge even if the sovereign has not transgressed. If both A and B challenge, the sovereign is deposed and any transgression attempted by the sovereign is rebuffed. If only one group of citizens challenges S, the challenge fails and any transgression attempt by S succeeds. Of course, if both A and B acquiesce, any attempted transgression succeeds.

14. The simultaneous move between A and B is represented in Figure 1 as follows: A moves first, followed by B, and the dashed ellipse or "information set" around B's two nodes indicates that B does not know A's decision when choosing his own move.

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Table 1. Payoffs for the Sovereign-Constituency Transgression Game

Sovereign's Move	Induced Subgame Between A and B (Payoffs: S, A, B)			
			B	
			Acq	Chall
Transgress against both	A	Acq	(5, 1, 1)	(5, 1, 0)
		Chall	(5, 0, 1)	(0, 3, 3)
			B	
			Acq	Chall
Transgress against A	A	Acq	(3, 1, 4)	(3, 1, 3)
		Chall	(3, 0, 1)	(0, 3, 3)
			B	
			Acq	Chall
Transgress against B	A	Acq	(3, 4, 1)	(3, 4, 0)
		Chall	(3, 3, 1)	(0, 3, 3)
			B	
			Acq	Chall
Transgress against neither	A	Acq	(1, 4, 4)	(1, 4, 3)
		Chall	(1, 3, 4)	(0, 3, 3)

Power is valuable to the sovereign, who receives 1 if he retains power. Successful transgressions are also valuable to the sovereign and are worth 2 each. A transgression against either group costs that group 3, reflecting the fact that there are economic costs associated with transgressions—for example, a loss of wealth. Challenging costs each challenger 1, regardless whether the challenge is successful.

The payoffs from this game are given in Table 1. Outcomes and payoffs are determined by the strategy combinations chosen by the three players. If S attempts to transgress against both A and B and both acquiesce, the transgression succeeds and the payoffs are: 5 to S, 1 to A, and 1 to B. If S attempts to transgress against both A and B and both challenge, the transgression fails and S loses power, resulting in payoffs of 0, 3, 3. The Pareto optimal outcome for society occurs when no transgressions or challenges are attempted (the parties obtain 1, 4, and 4, respectively).

Although more complicated than the standard Prisoners' Dilemma, the structure of this game resembles it. This holds because responding to transgressions is costly to each citizen group. Consider the set of incentives facing the citizens if S attempts to transgress against B. B prefers that both challenge. Notice, however, that A has a dominant strategy: no matter what strategy B plays, A prefers to acquiesce. Knowing this, B will acquiesce.

This structure of interaction allows the sovereign to transgress some citizens' rights and survive.[15] In the one-shot game, there are three pure strategy equi-

15. Throughout this analysis we use the concept of subgame perfection as an equilibrium concept, defined as follows. A *strategy* is a specification of the action a player will take at every branch

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libria, and the Pareto optimal strategy combination with no transgressions is not among them. Which equilibrium occurs depends in part on the reaction functions of the citizens' groups to a transgression. The worst outcome for the citizens—where the sovereign transgresses against both—is an equilibrium. This occurs if citizens acquiesce whenever they are the target of a transgression. Acting alone and taking the behavior of the others as given, each citizen group can only increase its costs by challenging; it cannot change the outcome.

On the other hand, A and B might both play a different strategy, namely that they challenge S if and only if both are the targets of a transgression. In this case, there are two equilibria, depending on which citizen group S chooses as a target. Suppose that S chooses to target B in every period and that A and B respond as just suggested. Then S has no incentive to deviate: transgressing against both leads to being deposed; transgressing against A instead of B is no better; and transgressing against neither leaves the sovereign worse off. Furthermore, neither citizen group has an incentive to deviate. For A, this conclusion is obvious. For B, it follows because B can do no better. Given that B alone is the target, and thus that A will not challenge, challenging will not change the outcome but will increase B's costs. Hence B is better off acquiescing if it alone is the target.

The situation is more complicated when this game is repeated, that is, when the interaction between the sovereign and citizens is ongoing. Given the structure of payoffs, the "folk theorem" applies, implying that virtually any outcome can be sustained as an equilibrium of the repeated game (Fudenberg and Maskin, 1986). In particular, any of the equilibria of the one-shot game is an equilibrium of the repeated game. The existence of multiple equilibria is a problem for prediction, an issue we return to below.

The folk theorem implies that the Pareto optimal outcome can be sustained. The key to this result, as with the one-shot game, concerns the behavior of each citizen group when the sovereign attempts to transgress against the other. The difference is that repetition provides the opportunity for citizens not only to punish the sovereign, but to punish one another. The Pareto optimal outcome is supported by both groups challenging the sovereign when the sovereign attempts to transgress against either. The reason why that behavior can be supported under repeat play is that, as in the repeated Prisoners' Dilemma, the players can use "trigger" strategies to punish one another for failure to cooperate. If, for example, A fails to challenge the sovereign when the sovereign attempts to transgress against B, then B can retaliate by failing in the future to challenge the sovereign whenever the sovereign attempts to transgress against A. This behavior by B allows the sovereign to transgress successfully against A.

B's trigger strategy provides A with the following strategy choice. It can acquiesce today, avoiding the cost of 1, and then face losing 3 in all future periods; or it can challenge today, costing 1 but maintaining 3 in all future

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of the game tree. An *equilibrium* is a set of strategy combinations in which no player has an incentive to deviate given the strategies of others. The equilibrium is *subgame perfect* if it remains an equilibrium when restricted to every subgame.

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periods. Clearly, when A does not discount the future too heavily, it will prefer the latter, so that B's threat strategy induces A to challenge the sovereign when the latter attempts to transgress against B alone.

Unfortunately, the Pareto optimal outcome is not the only equilibrium. Although that equilibrium is normatively attractive, it will not inevitably occur. The game might instead yield any of the three equilibria of the one-shot game, allowing successful transgressions against some or all citizens. In particular, the sovereign may transgress the rights of some citizens while retaining the support of others.

So far, we have taken the definition of a transgression as given, ignoring the content of the underlying views of individuals about these transgressions. The most natural way to interpret a transgression in the model is as an act directed against a group of citizens—for example, an attempt to confiscate their wealth. Another subtler way to think about a transgression is to disassociate it from the target. For many citizens, the importance of a transgression lies in its nature, regardless of who is the target. This view of transgressions implies that citizens have a duty to challenge the sovereign when the latter attempts a transgression, regardless of the target. This view still allows for a diversity of opinion over what acts constitute transgressions. The question then becomes, given this interpretation of transgressions and citizen duty, what combinations of beliefs about the nature of transgressions can be supported in equilibrium?

Given the second interpretation of a transgression, one way to think about the problem of multiple equilibria is that the question of which equilibrium will occur depends on the diversity of beliefs about transgressions and about citizen duties when the sovereign attempts to transgress against other citizens. Indeed, as Ferejohn (1990) argues, in the context of multiple equilibria, we can suggest which equilibrium will result if we know the pattern of beliefs in a society.

In the present context, Ferejohn's argument implies the following. Suppose there is a diversity of preferences over outcomes, especially if citizens' economic circumstances differ considerably—some might be wealthy elites, others successful commercial agents or economic entrepreneurs, others farmers who own their land, still others peasants who work land they do not own. Under these circumstances, the nature of citizen views about the appropriate role of the state and what actions constitute a transgression are likely to differ widely. Because there is no automatic mechanism to produce a consensus on these issues, the most natural equilibrium of the game is the asymmetric one. Put another way, the diversity of preferences impedes the development of the Pareto optimal equilibrium, making it more likely that the game will result in one of the asymmetric equilibria in which the sovereign transgresses the rights of some and retains the support of others.

Ferejohn's argument also implies that, for those issues over which citizens agree about the nature of a transgression, the Pareto optimal outcome can be supported. When the state of agreement in society is large, producing something approaching a consensus, a sovereign who attempts to transgress against citizens cannot survive.

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Summary and Implications. The model shows that it is costly for the citizens to police the sovereign or government. Policing limits on the state requires that citizens be willing to bear this cost when the state violates them. Yet if citizen beliefs about the appropriate limits on the state differ considerably, it is difficult for them to react in concert to state actions. Indeed, this diversity allows the sovereign to form a coalition with one group of citizens against another, allowing the sovereign to transgress boundaries considered fundamental by other citizens.

This approach models the problem of policing a state or sovereign as a coordination problem. In this context, a constitution serves as a coordinating device, helping citizens to coordinate their strategy choices so that they can react in concert and police state behavior.[16] An appropriately chosen set of public rules embodied in a constitution can serve as a coordination device because it provides each citizen with a similar way of judging and reacting to state action. Of course, the availability of such a mechanism in principle does not tell us under what circumstances it may be used in practice. This approach demonstrates that a central step in the creation of limited government is that citizens or their representatives construct a mechanism that solves the coordination problem.

2.1.2 Application of the Model to the Glorious Revolution. This model has considerable implications for the constitutional changes following the Glorious Revolution in England and the rise of a national consensus about the appropriate boundaries of the state. Two aspects of market-preserving federalism allowed the industrial revolution to take place outside the traditional commercial areas: decentralized regulatory authority, which allowed local variation in economic controls; and the absence of national regulatory authority to extend economic controls to cover those areas that did not have them. A range of elements contributed to this result. The most important from our standpoint was the strengthening of the rule of law at the end of the 17th century, whereby a consensus emerged opposing national economic intervention.[17]

The 17th century saw considerable political turmoil. Within a decade of the accession of the Stuarts in 1603, problems emerged between the sovereign and many of his citizens. The century included a civil war and the beheading of the king (1640s), a restoration of the monarchy (1660), and the Glorious Revolution (1688–89), which deposed the last of the Stuart kings, James II, in favor of William and Mary.

Throughout the century, the citizenry was deeply divided over the role of the sovereign, the appropriate limits on state behavior, and the benefits of var-

16. This point is made generally by Hardin (1989).

17. Other aspects include: first, among all states in early modern Europe, England had the strongest tradition of private property rights; second, after the Glorious Revolution, Parliament counterbalanced the Crown, by and large opposing national economic intervention.

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ious public policies. By century's end, two political coalitions had emerged, called Tories and Whigs. Whigs were more focused on commercial activities, favored secure property rights, advocated low and stable taxes on economic activity, and took an activist profile in international relations to promote and defend their economic claims around the world. They also sought explicit limits on the sovereign's behavior. Tories, on the other hand, cared much less about commercial activity, wanted a limited international presence, and preferred low and stable taxes on land, their primary source of wealth. They also strongly supported the Church of England and opposed explicit limits on the Crown.[18]

During the reign of the late Stuarts (from the Restoration to the Glorious Revolution) and especially by the mid-1670s, the Tories supported the Crown while the Whigs opposed it. Moreover, the late Stuarts transgressed significant rights of the Whigs while retaining the support of the Tories. The most important sovereign transgression concerned the campaign to "pack the constituencies." In the early 1680s, the Crown began to disenfranchise the major sources of Whig opposition. The strategy proved a huge success.[19]

Although the events that occurred next are straightforward in outline, the explanation for them has been debated for more than 300 years. First, the initiator of the campaign to disenfranchise the Whigs, Charles II, died and was succeeded by his brother, James II. Second, for a variety of reasons, there was considerable suspicion between James and his supporters. Not long after taking power, James became embroiled in a dispute with the Tories and reacted by attempting to disenfranchise them. Although this attempt nearly succeeded, it ended in dismal failure. The result was a political nation united against James II, forcing him to flee.

The Glorious Revolution was more than a simple coup, however, for it also resulted in significant constitutional changes. James's behavior convinced the Tories that explicit limits on the sovereign and the state were required. Although the two coalitions disagreed about the content and role of these limits, they agreed not only that limits were necessary, but so too was a consensus about those limits (Schwoerer, 1981). The result was the Revolution Settlement passed by Parliament in early 1689. From our standpoint, the key is the Bill of Rights, a set of two lists. The first identified those actions of the previous sovereign that constituted fundamental violations of citizens' rights. The second listed activities that the sovereign could no longer undertake. Although sovereign power would wax and wane over the next century, the limits established in the Revolution Settlement were, by and large, adhered to.

18. "It is an oversimplification to see the Whigs as the party of business and the Tories of seigneurial power. . . . But one can safely contrast emphasis on commerce as a point in the Whig profile, and emphasis on agriculture as a point in the Tory one. So, too, the Whigs tended to internationalism . . . while the Tory was inward-looking and protectionist" (Carswell, 1973: 40–41).

19. Jones (1972: 47) reports that of the 104 formerly Whig strongholds rechartered between 1681 and 1685, only one returned a Whig to the next parliament in 1685.

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2.1.3 Sustaining Market-preserving Federalism in England. These events are readily interpreted in terms of the model above. Before the Revolution, citizens fundamentally disagreed about what actions they considered violations of their rights. Marked divisions in 17th-century England prevented the formation of a shared system of beliefs about critical matters such as the role of the state, the limit of sovereign power, citizen duty, and the appropriate definition of economic and political rights. The diversity of beliefs allowed the Crown to transgress rights held as fundamental by the Whigs as long as the Tories were willing to acquiesce. This described the situation from at least the mid-1670s through the mid-1680s. This pattern of transgression was seemingly stable, reflecting the nature of the asymmetric equilibrium of the game.

James's move against his own constituents broke this pattern, losing him the support required to retain power. Not only was he removed from power, but his actions caused a wholesale and speedy revision in opinions and beliefs about fundamental issues. This change led to the construction of a new consensus that provided a clearer definition of the legitimate actions of the state and of citizen duty.

These changes reflect an attempt to construct a coordinating device. Constitutional innovations, such as the Revolution Settlement and its Declaration of Rights, were designed, in part, to define what actions constituted a fundamental transgression. The new consensus was critical to preventing further transgressions. According to Jones (1972: 318):

> The thirteen points in the Declaration were not just statements of the true nature of the law of the constitution, they were also intended to provide a guideline for the future conduct of government, so that any departure from legality would be instantly signalled, and remedial action could be taken.

This is precisely the mechanism modeled above. Because the new boundaries were both explicit and consensual, they fundamentally changed the interaction between the citizenry and the new sovereign. For many of the central political issues of the era, a single set of limits on sovereign behavior had been negotiated by leaders of the opposing parties. This process resulted in a set of shared beliefs about what constituted a fundamental transgression by the state and about what citizens should do in the face of these transgressions. These shared beliefs implied that citizens would react in concert against any future sovereign transgression, thus ensuring that their political and economic rights were more secure.[20]

But how did this new coordinating mechanism translate into protection for federalism in England? Given the distinct hierarchy in English government, the main question as to whether post–Glorious Revolution England had market-preserving federalism concerns the limits on national regulatory authority.

20. Reflecting the achievement of coordination, the American Justice Bradley, writing in the late 19th century, observed that a constitutional violation "would produce a revolution in an hour" (J. Bradley's dissent in the *Slaughter House Cases*, 1873).

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After the Glorious Revolution, citizens more closely guarded local power, authority, and autonomy. Because violating local political liberty had been the principal factor in the campaign to pack the constituencies—and hence in the Revolution—citizens throughout England were wary of national interference with their authority. As Miller (1992: 53) suggests:

> The right, in most towns, to practice a particular trade or take part in municipal government was confined to a comparatively restricted group of craftsmen and traders possessing the "freedom" of their town or craft guild which gave them rights denied to other citizens. Municipal and other corporations (including colleges and universities) had been granted (usually by the Crown) the right to a measure of control over their own affairs: here "freedom" meant immunity from outside intervention.

Local political freedom thus emerged as part of the constitutional consensus at the end of the 17th century.[21]

By way of summary, national interference with local power during the campaign to pack the constituencies produced a consensus that protection of local power against national interference was essential to the maintenance of individual liberty and security. The consensus was embodied in the Revolution Settlement, an important addition to the English constitution. This explicit agreement served as a coordinating device necessary to establish the equilibrium in which citizens react in concert to violations of the limits on governmental action.

Though the Glorious Revolution was largely backward looking, in the sense that its limits were intended to prevent transgressions by the sovereign, it had important—if unintended—forward effects on the economy. By strengthening local power and limiting the ability of the national government to intervene in the economy, the new English constitutional system provided for market-preserving federalism. This in turn proved a critical political component of industrial revolution, for it allowed local governments to ignore, avoid, or repeal the regulatory restrictions on the local economy that economic historians have emphasized were crucial to the success of the new entrepreneurs and enterprises.

2 2 The Durability of Federalism in the United States

The United States had market-preserving federalism from the inception of the Constitution through the mid-1930s.[22] During this period, what made market-preserving federalism durable—that is, what prevented the federal government

21. An additional element limited national authority to regulate: the elevation of the common law courts as the protector and promoter of private property rights. This effectively removed many decisions about property rights from national politics. One of the central consequences of the Glorious Revolution was also to establish an "independent" judiciary much less subject to political manipulation.

22. What follows draws on Weingast (1993a, 1994a).

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from overawing the states? The immediate answer—that the Constitution prevented it—begs the question, for it ignores the issues of constitutional interpretation and constitutional adherence.

At the most fundamental level, the answer to the question is that not only did the Constitution proscribe intervention, but the vast majority of Americans favored this outcome. A national consensus supported the limited role of the federal government. Because this view was so widely held, all the major parties before the 1930s championed it (first, the Federalists and Jeffersonians, then the Democrats and Whigs, and finally the Democrats and Republicans).[23] National parties not only promoted the view of a limited federal role, but created and maintained a series of institutional mechanisms designed to provide a credible commitment to limited federal government.

To see how the consensus translated into the mechanisms of Constitutional durability, consider the problem during the second party system, roughly 1828 through the early 1850s. During this time, the nation was divided into free and slave states. This division had a critical influence on American history, notably, on the interpretation of the Constitution, the three major antebellum political crises, and the Civil War and Reconstruction.[24]

Most citizens were deeply suspicious of the national government because of its potential to impose policies favored by other regions or interests. Early in the 19th century, before the rise of an integrated, interregional economy, the solution was simply for both North and South to agree to limit the federal government's authority, thus limiting the ability of either region to impose its will on the other. Although the partisan debate involved the role of the federal government in the economy, the range of involvement was relatively circumscribed, limited to such issues as tariffs and internal improvements.

The "balance rule," or the equal representation of the North and the South in the Senate, served as the principal institution providing durability to the agreement between the regions. The balance rule afforded each region a veto over national policymaking. As I argue at length elsewhere, this institution had a profound effect on national politics (Weingast, 1994a; see also Roback, 1994). The main implication for present purposes is that the set of concurrent vetoes prevented national policies that were considered especially inimical by either region. The balance rule's double veto thus provided the political foundations for the preservation of a slave economy in the South, a free one in the North, and a limited national government.

As the economy became interregional, however, many policy questions were no longer so easily disaggregated. For example, should growth of interregional

23. The one possible exception to this unanimity was the Republican party on the issue of slavery and the rights of the freedmen. These policies emerged only within the context of the Civil War. A version of the view that follows applies to the bulk of the policies they devised and implemented during their period of political hegemony (1860–1932).

24. Other political divisions were also important, but in what follows we concentrate on the former. For a discussion of the interaction of slavery and other issues during the period of the second party system, see Weingast (1994a).

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trade be subsidized by federal support for roads, canals, and, later, railroads? Should national and agrarian expansion be encouraged via low prices for federal land on the frontier? At about the same time, the Missouri crisis (1818–20) convinced Southerners that the national government's authority might be used against their "property" and their "institutions"—that is, against slavery (Carpenter, 1930).

In the late 1820s and early 1830s, the Jacksonian Democrats tried to form a political coalition to retain national political power. In responding to the political questions noted above, they articulated a set of policy goals consistent with limited federal government and a constitutional jurisprudence of states' rights to underpin these limits. The Jacksonian appeal was built on a set of principles that provided considerable security for slaveholders, helping this party secure majority support in the South and in the nation. This approach held considerable appeal to Southerners seeking to forestall any precedent for expanding the scope of national authority. But it also appealed to many Northerners, particularly throughout the old Northwest and among laborers and farmers in the East.

The Democrats' approach allowed them to dominate national elections and hence to control national policy.[25] Their successes depended on more than mere campaign promises and reputation. Indeed, the Jacksonians added a series of political institutions to provide their officials with incentives to implement and adhere to their policies. Three instances of institutions and practices are worth noting. First, the Democrats articulated a constitutional jurisprudence of states' rights, avoiding any precedents for increased national authority. As their Supreme Court appointments reflected these views, they led to compatible constitutional decisions. Second, as part of their appeal to Southerners, they adopted the two-thirds rule for nominating candidates to the presidency (Potter, 1976; Weingast, 1994a). This granted Southerners a veto over their party's presidential candidate, assuring them considerable influence not only over their party's candidate but—as the Democrats held the presidency in three-fourths of the Congresses between 1828 and 1860—over the presidents as well. Third, they were willing to maintain the balance rule at the national level, assuring the South a veto over national policy via its equal representation in the Senate. Expansion and imperialism were rationalized by "manifest destiny." Given the centrality of slavery to the South, significant slippage between promise and implementation would clearly ruin the party's ability to compete in that region and thus, as all knew, its ability to maintain its majority position.

This argument shows how the Constitution and allied institutions provided the principal mechanisms of political decentralization inherent in federalism during the second party system. Because the majority party in the nation favored that position, it was able to maintain strong limits on national government both

25. During the 16 Congresses between the elections of Jackson and Lincoln, the Democrats held all three national institutions in 9 of 16 Congresses, whereas the Whigs held all three only once. The Jacksonians also dominated Supreme Court appointments. From 1828 to 1860, 11 justices were appointed under united Democratic control, 2 under divided control, and none under Whig or Republican control (see Weingast, 1994a).

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as official policy and as constitutional law. The majority party in the nation proved instrumental in translating a broad, national consensus for limited federal government into a series of institutions making those limits credible.

The argument in this section exhibits strong parallels with the approach developed in Section 2.1. Underlying the limited role of the federal government was a national consensus that this was appropriate. Although no sovereign was relevant for the United States, a parallel problem existed between the two groups of citizens: each worried that the other might come to dominate the national government, allowing it to use national power for its own regional purposes. Because the problem was symmetric, both sides agreed to limits on national authority as a means of limiting the ability of the other to dominate. This agreement, in turn, required a combination of institutions and attitudes to succeed. The institutions ranged from federalism and the commerce clause discussed above, to the various attempts to provide regional balance in the Senate. These institutions, in turn, fundamentally rested on the attitudes and preferences of citizens, requiring that the vast majority in the nation believe these agreements were appropriate. Problems emerged only at the end of the second party system when a new party, the Republicans, proved no longer willing to maintain these institutions, notably, the balance rule (Weingast, 1994a).

3. Implications for Economic Reform

3.1 Federalism Chinese-style: Economic Growth in Modern China

The contrast between the success of economic reform in southern China and the troubled path of reform in the former Soviet Union and its satellites not only is striking but appears to reflect the lessons of this article.[26] Beginning in the late 1970s, China embarked on economic reform. As one of Asia's fastest-growing economies in the past 15 years, it has had remarkable success, especially in the south.

A range of factors has contributed to China's economic success relative to the former Soviet Union. These factors include, for example, the proximity of South China to foreign capital, notably family wealth of those who had previously fled the communists to Hong Kong or Taiwan; the relatively limited initial scope of economic reform, perhaps including its focus on agriculture while ignoring the large-scale public enterprises; in contrast to the former Soviet Union, China's relatively shorter experience with communism, its leaders' more pragmatic and less ideological pursuit of socialist economic principles, and a far less interdependent economy. Moreover, in contrast to the republics and satellites of the former Soviet Union, which inherited a range of economic and fiscal problems from their former regimes, China initiated the reforms from a position of relatively strong fiscal health.

All of these factors contributed to China's success. And yet these and related factors provide an inadequate understanding of that success. A central though

26. These ideas are pursued at greater length in Montinola, Qian, and Weingast (1995) and Qian and Weingast (1995).

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underemphasized factor of China's economic reform is that it was initiated with political reform. As applied to China, the term *political reform* usually refers to democratization. Democratization is clearly a central task of political reform, one of sufficient value that it receives special attention. Yet it reflects only one aspect of politics and political reform. In what follows, I use the term in its broader sense (see Montinola, Qian, and Weingast, 1995).

As part of the effort to pursue economic reform, the Chinese central authorities instituted a form of political decentralization that limited their own power. This decentralization produced a form of market-preserving federalism. This federalism, Chinese-style, differs considerably from Western-style federalism—for example, in having no connection to individual rights and political freedoms. Nonetheless, China's political system approximates the five necessary characteristics of market-preserving federalism identified above.[27]

Critical to China's economic success, the new decentralization affords local governments considerable discretion over economic policy. In many areas, officials have used this authority to create markets and entrepreneurial enterprises, and it is these areas that are experiencing the most significant growth. The economic effects of the decentralization have been felt in the growing entrepreneurialism found at the local level and the growing participation of these enterprises in international markets (Byrd and Lin, 1990; Montinola, Qian, and Weingast, 1995; Nee, 1992; Oi, 1992; Qian and Xu, 1993; Walder, 1992).

Underpinning this success was the central government's seeming toleration of the loss of political control over local economic policy-making. This has had two effects. First, it has lowered the influence and importance of the relevant ministries of the central government and hence of central planning. Second, the incentives of local political officials changed dramatically. With the growing success of economic reform, local revenues came to depend on the economic health of the local economy, not on political allegiance to the central government or conformity to a central plan. Parallelling the incentives facing the English justices of the peace during the industrial revolution, decentralization in China provided many local political officials with the incentives to create an economic and political environment that fosters economic growth. In both 18th-century England and modern China, prospering economic enterprises provide an expanding local resource base, aligning the interests of local officials with local economic success.

The loss of central government influence and control over local officials provides the answer to why the critical second condition of market-preserving federalism holds. The process by which the decentralization was initiated sheds considerable light on how durable limits on government are established. Decentralization was established by decree, and, initially, it had no special durability. Nonetheless, the degree of support among the central authorities,

27. One notable exception is the presence of internal trade barriers. The economic costs of these provisions are unknown. Most of China's growth has occurred in the areas with the fewest barriers to the rise of an export economy.

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notably Deng Xiaoping, led to a range of experiments, emphasizing aspects that could be changed in the short run and that did not leave long-term investments vulnerable. As these proved successful and the central government did not revoke them, they were expanded and imitated. As the process continued, local incentives gradually changed from those promoting allegiance and control by the central authorities to those reflecting local economic prosperity. Thus the durability of the reforms did not arise all at once but grew as the degree of economic success increased.

The central government's loss of control over local officials directly limits its ability to intervene adversely in these new markets. Short of using the army—still under national control and therefore potentially a factor in the future—the central government no longer appears able to reverse its political, and hence economic, reform efforts.

The Chinese government's failed effort to halt or reverse economic reform after Tiananmen Square suggests the durability of the political reforms. At that time, the conservatives gained the most political, ideological, and military power. If ever they had sufficient power for a reversal of reform, that was it. Moreover, economic woes of inflation and corruption in 1988 and the following political backlash after the Tiananmen Square incident in 1989 also put economic reform on hold. An austerity program was implemented between 1989 and 1991 to cool down the so-called "overheated" economy. In 1990, there were even discussions among conservatives about the possibility of recollectivization of agriculture.

Several events combined to undo the central government's attempted reversal. First, many areas of the economy began to decline, raising fears of unemployment and vast new fiscal commitments for the central government without a concomitant expansion of fiscal resources. Second, as part of the government's campaign, it attempted to promote the large, state-owned enterprises. This effort not only failed to produce results but had significant, negative fiscal consequences. Third, the economic retrenchment was resisted by local officials from the areas experiencing the highest economic growth, officials who had no interest in seeing the retrenchment succeed. Li Peng, the conservative premier, failed in his attempt to recentralize investment and financial powers from the provinces. The governor of Guangdong refused, and many other governors followed suit (Shirk, 1993).

This incident emphasizes the striking new power of local governments, power not held during most of the communist era.[28] The abandonment of retrenchment revealed that the government was unwilling to pay the price of reversing the reforms. This, in turn, reduced the political uncertainty about the durability of the reforms.[29] The new decentralization limited the discretion of the central

28. In contrast, on several previous occasions when the economy faced difficulties (for example, in 1962, and as recently as 1981), Chen Yun, an advocate of central planning, successfully compelled the provincial governments to "help the central government overcome the difficulties"—that is, to turn over more revenue to the central budget.

29. Growth rates since the abandonment have, if anything, been higher than before the retrench-

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government, adding an important degree of durability to the reforms. Barring extreme events, the reforms have become a central component of modern China.

A number of important qualifications to China's economic success must be raised. First, China's strategy for economic reform has put off dealing with the extensive and growing problem of the state enterprises, including their large subsidies (see Wong, 1991). Second, the decentralization of power has not been uniform, explaining in part why reform has varied across regions. Third, critical national public goods remain underprovided. The common market is inadequately secured, and considerable internal trade barriers remain across regions, including barriers to labor migration. In some areas, local officials have taken advantage of political decentralization to protect local enterprises, raising complaints about rising "dukedom economies." Considerable problems also arise from the lack of centralized control over the monetary system, resulting in softness of budget constraints and in inflation. Fourth, a large number of tasks of economic reform emphasized by economists have yet to be tackled (e.g., a law of commerce or credit). The mechanisms for enforcing long-term agreements with sources of foreign capital remain underdeveloped. Finally, given the aging octogenarians underpinning the central government's reform effort, uncertainty over political succession implies a degree of political risk. Considerable uncertainty remains about the possibility of an antireform backlash, and hence about the course of Chinese reform.

4. Conclusions

The main lesson of this analysis for contemporary development and economic reform is a variant on the now commonplace observation that the benevolent attitude of the government cannot be taken for granted:[30] Markets require protection and thus a government strong enough to resist responding to the inevitable political forces advocating encroachments on markets for private gain. The fundamental political dilemma of an economic system is that a state strong enough to protect private markets is strong enough to confiscate the wealth of its citizens. The dilemma implies that understanding economic growth requires attention to the question of what guides the state down the former path. As North (1993: 11–12) argues:

> Throughout most of history and in much of the present world, institutions have not provided the credible commitment necessary for the develop-

ment. The *Economist*, for example, reports that they have been over 20 percent per year in some areas. This is consistent with the view that removing a degree of political risk increased expected economic returns, thus enhancing the willingness of entrepreneurs and investors to undertake actions promoting growth. Similarly, since early 1992, Hong Kong has felt a new optimism. The increasing ties of Hong Kong's economy to that of South China are one factor contributing to the durability of Hong Kong's economy. Unfortunately, as recent events remind us, it is not the only factor.

30. On the limits of assuming a benevolent government in the developing context, see, among others, Campos and Root (1994), Ekelund and Tollison (1981), Krueger (1992), Levy and Spiller (1994), North (1981, 1990), North and Weingast (1989), Przeworski (1990), Root (in press), Weingast (1994a, 1994b), and Williamson (1994).

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ment of low-cost transacting in capital and other markets. There is, therefore, little evidence to support the view (apparently implicitly held by many economists doctoring the ailing economies of central and eastern Europe) that the necessary institutions will be the automatic outcome of getting the prices right through elimination of price and exchange controls.

Put simply, the political foundations of markets are as essential to their success as the details and specification of the market itself. This conclusion implies that markets and limited government are complementary aspects of economic development and reform; each enhances the value of the other. Political development must therefore take place simultaneously with economic development.

Limited government, in turn, requires that restrictions on the government be self-enforcing. Although this claim is made regularly in the literature, few analyses have shown how constitutions actually accomplish this difficult task in practice. The possibility of beneficial limits on government is not realized automatically. This observation forces us to ask what makes those limits credible—that is, what makes them binding on political actors? To address this question, I have examined here how England and the United States grappled with these problems in the past and how China is grappling with them in the present. Although a range of considerations is important, I have focused on the institution of market-preserving federalism, a central factor in the economic development of all three.

Several facets of federalism account for its success in England and the United States. First, federalism provided the political basis for the common market. Second, the prohibitions against the national government's exercise of economic regulation greatly reduced the government's political responsiveness to interest groups. In a growing economy, this limited the ability of economic interests, potentially displaced by economic change, to use political means to constrain or prevent their competitors' success. Third, the prohibitions on internal trade barriers allowed entrepreneurs, new enterprises, and new economic activities to emerge in new areas that could outcompete interests in older areas. In England, these factors provided the political foundation for the success of the industrial revolution. In the United States, they fostered first regional and then international specialization, underpinning American economic growth.[31] By creating credible restrictions on governmental policy choice, federalism provided the basis for the rule of law and hence the political underpinnings of economic freedom.

Yet what made these restrictions credible? What made them binding in practice? Though the details differ considerably, both cases reveal that federalism's success in practice relied on a mix of formal and informal constraints. As North

31. As Casella and Frey (1992: 640) argue: "If private economic decisions are influenced by public goods, ... as we expect them to be, then markets and institutions should develop together."

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(1993) emphasizes, it is not only the institutions of society that help provide for secure rights, but a mix of institutions and complementary informal norms that constrain the behavior of the players at numerous margins. It is this mix of formal institutions and informal norms that I now wish to stress, for the first two points received considerable emphasis above.

The critical feature for England and the United States is that the success of constitutional constraints promoting the rule of law depended on the emergence of a social consensus about the appropriate limits of the state. Holding the state to prescribed limits does not depend on a constraint being explicit, nor does it require that it might have been agreed on at some time in the past. Limited government instead depends on how citizens react to a potential violation of that constraint. The ultimate sanction on a government is the withdrawal of support by a sufficient portion of its citizens so that the government cannot survive.

The failure of this form of citizen reaction allows a host of constitutional violations in Latin America and other parts of the third world (see, e.g., Montinola's 1994 discussion of Marcos's rejection of the Philippine Constitution). Notice, in contrast, the reaction to President Franklin Roosevelt's famous court-packing scheme. Although it was proposed at a time of unprecedented political support for Roosevelt and the New Deal, and although it was designed to benefit his constituents, it was deemed illegitimate by a sufficient number of his supporters that its future was highly questionable.[32]

For both England and the United States, the decentralization of political authority implied by market-preserving federalism was the product of a historical process resulting in a strong consensus supporting these limits. The English state's failure to respect citizen rights in the late 17th century led not only to the Glorious Revolution but to a new consensus about the appropriate limits on the national government's authority. Constructed through negotiations in Parliament among the leaders of the various factions in society, the consensus over limits was embodied in a new set of constitutional arrangements, including increased reliance on the common-law courts rather than royal discretion, increased security of property rights, and concern for the maintenance of local political authority, especially in matters of economic control and regulation. These arrangements at once created the political decentralization necessary to support market-preserving federalism and the national consensus to provide it with durability.

During the first 150 years of the United States, the foundations of market-preserving federalism rested on the fact that the vast majority of the population consistently favored policies and parties limiting the federal government and protecting economic rights. The two breakdowns of this consensus underscore its role and importance. The first concerned the role of the federal government with respect to slavery and resulted in a civil war. The second—and

32. Roosevelt did not pursue this scheme for several reasons, most notably that the Supreme Court itself reversed direction in early 1937. For a recent review, see Gely and Spiller (1992).

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permanent—breakdown occurred during the Great Depression. At that time, a new political majority emerged. The new majority not only resulted in expansion of the national government beyond the traditional limits of the Constitution, but engineered a reinterpretation of the principal constitutional constraints underpinning market-preserving federalism. Within five years, the latter were removed.

The discussion of economic reform in China also emphasizes the importance of the economic role of political institutions. Because the problems faced by China and Russia are very different, strong conclusions cannot be drawn from a brief comparison between them. Nonetheless, it is striking to note not only the enormous difference in the approaches to reform, but their relative degrees of success. The former Soviet Union, and later Russia, concentrated on reform of its economic system, retaining strong discretionary powers for the government. No attempt was made to establish limited government or to tie the government's hands with respect to future economic policy (Boettke, 1993; Litwack, 1991; Williamson, 1994). Although there has been some attempt to institute political rights and democracy, these limits on the government do not yet extend to economic rights or the basic structure of the economic system. As Ordeshook and Schwartz (1994) emphasize, all rights in Russia—personal, property, and democratic—remain highly insecure because of the liberal clauses in the Russian Constitution that allow the government to suspend these rights when they prove inconvenient.

In contrast, China began with a political reform in which the central authorities, although not completely binding their own hands, made it much harder to use those hands. The central government limited itself by transferring power to local authorities in a way that would be difficult—and that recently proved difficult—to retake. This transfer, in turn, set the stage for a series of economic transformations across much of China. For local governments, political freedom and political protection from the central state combined with economic opportunities to provide strong incentives to foster and protect markets. The results are remarkable. Moreover, the economic effects of local political freedom in China exhibits some striking parallels with those in 18th-century England. In both cases, local political officials had strong incentives to foster local prosperity, underpinning the rise of new and very successful firms.

For the emerging democracies of Eastern Europe and the former Soviet Union, this analysis suggests that economic and political institutions should be redesigned simultaneously. In particular, these institutions need to be consistent with one another. What economic incentives are implied by the degree of discretion afforded the government under the political institutions? Are they compatible with secure property rights and the development of the rule of law?

The three cases of federalism studied here do not constitute a test of the theory, for they were not randomly selected. Putting the theory at risk requires a more systematic investigation of market-preserving federalism, attempting to test whether states characterized by its provisions reveal appreciably more economic development than those not so characterized. Although such a test is beyond the scope of this study, we do mention that other instances of de jure

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federalism, but not market-preserving federalism, appear to have fared much more poorly than the cases studied here. Argentina, Brazil, and India are all de jure federal systems but not market-preserving federal systems. In all of these countries, the political authority of the national government compromises the independence of local political authority. On the critical dimension of economic performance, none of these states has experienced economic development that parallels the cases studied here.

In sum, I have argued that securing the political foundations of markets must be accomplished at the same time and is equal in importance to the development of markets and "getting prices right." The historical evidence presented above supports this position (see also North, 1981, 1993). The discussion of reform in China further suggests that limited government appears to be an important component of economic reform. It emphasizes the critical *economic* role for *political* institutions—to provide the appropriate foundations for economic policy-making and a secure system of economic and political rights.

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