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Federalism and industrial policy: competing away government failure?

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FEDERALISM AND INDUSTRIAL POLICY

Competing Away Government Failure?¹

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Abstract

Industrial policy hovers in the intellectual space between market failure and government failure. Can subnational competition overcome government failure and make industrial policy more effective? The empirical evidence is limited and inconclusive. This paper analyzes the first and second-order effects of federalist reforms, and then distinguishes 'between' vs. 'within'-competition. Federalism's first-order effects are on public sector efficiency, effectiveness, and the quality of public decision-making – that is to say, government failure or success. It only affects industrial policy indirectly, through this channel. When diverse economic interests and civic groups interact through politics to reveal, debate, and trade off their competing interests, and so fashion policy, government will tend to be responsive and accountable. Where economic interests are homogeneous or civil society is inert, government failure looms. Further second-order effects of federalism include increasing the level of competition in a political system, and limiting the power of government against citizens in ways that make democracy compatible with open access regimes. Industrial policy is far more likely to succeed in this context due to greater economic participation and dynamism.

¹ I am grateful to Ha-Joon Chang, Luke Jordan, Tom Kenyon, Katerina Koinis, Mushtaq Khan, Mariana Mazzucato, Stefano Negri, and Charles Sabel for illuminating discussions, and to seminar participants at the "Making Growth Happen" conference for their thoughtful suggestions. All remaining errors are my own.

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1. Introduction

The pro-market, deregulating economic policy reforms of the 1990s and 2000s failed to generate sustained growth in the most enthusiastic reformers, such as the US and UK, delivering instead the 2008-09 financial crisis, followed by a painful, drawn-out, recession that has yet to end. The reality of policy failure has combined in recent years with the determined advocacy of structuralism by development thinkers such as Ha-Joon Chang, Robert Wade and Joseph Stiglitz to lift industrial policy out of intellectual cold storage and return it if not into the mainstream, at least on the agenda of policy thinking about development. Wade's (2012) article heralding the return of industrial policy, along with the success of books such as Chang (2011), and Stiglitz (2010), the creation of the Competitive Industries and Innovation Program at the World Bank, and indeed the fact that a conference on industrial policy such as the one for which this paper was prepared is hosted by the Bank, all underline this last point.

The question of industrial policy hovers in the intellectual space between market failure and government failure. One's position on industrial policy largely flows from which peril one considers to be more pervasive, or to have worse welfare consequences. Market failure refers to situations in which market incentives lead to inefficient provision of important goods and services. Where development is concerned, some of the most important market failures include the under-provision of research and development, and knowledge more generally, public goods and private goods with significant spillovers, goods or sectors where policy uncertainty strongly affects expected returns, the coordination of private investments that are complementary, and "strategic" goods with large network effects, such as roads, railways, or telecommunications, which can spur the development of new businesses in a variety of sectors that are hard to predict. The existence of such market failures is a prima facie argument for government action, and many of the failures listed above further argue specifically in favor of industrial policy.

Government failure can be defined as government action, often prompted by an attempt to correct market failure, that leads to greater inefficiencies in the allocation of resources. Government failure can come about through a variety of mechanisms. Two of the most obvious occur when public decisions are taken by officials who are corrupt

or captured by specific interest groups, leading to policy decisions or resource allocations that deviate from what is socially optimal. Other, less intentional government failures occur when the public sector crowds out private borrowing, or through simple miscalculations and mistakes by well-intentioned public officials. Chang, Wade and others argue vigorously that all countries that ever developed rapidly used industrial policy. But even they admit that the developed world is littered with the wreckage of failed public investment projects and failed industrial policies. How can industrial policy practitioners work to correct market failures without incurring government failures that are worse?

In recent years the claim that decentralized or federal³ competition can help to overcome government failure, or is even necessary for industrial policy to work, has gained currency. Local and regional governments, it is argued, compete over public goods in their attempts to gain political popularity and win elections. This will lead to rapid policy evolution at the subnational level, adaptive, localized implementation of policy initiatives, and higher growth. For evidence, proponents point to what they often call 'regionally decentralized authoritarianism' in countries such as China and Vietnam, where federal industrial policy is seen as crucial to sustained high growth rates. Opponents, by contrast, claim that attempts to give subnational control over industrial policy will lead instead to a fiscal 'race to the bottom' via investor tax breaks, as we have arguably seen in countries such as the US and Brazil. And proponents seem unable to point to direct evidence that regions and localities actually do learn from each other vis-à-vis industrial policy.

What systematic evidence can the empirical literature shed on this question? The literatures on decentralization and fiscal federalism are huge, numbering the hundreds of peer-reviewed studies in academic journals; add in the "gray literature" of international agency and NGO (e.g. World Bank, IMF, Oxfam) reports and studies and the number ascends into the thousands. This is in no small part because decentralizing reforms have proved hugely popular all over the world. In 1999 the World Bank

³ For purposes of the argument laid forth in this paper, the terms decentralization and federalism will be taken as indicative of the same broad class of reforms, which empower subnational governments by endowing them with significant administrative authority, resources, and political accountability. This does not deny the specific differences between decentralizing vs. federal reforms, nor the distinct literatures that have grown up around each.

estimated that an estimated 80-100% of the world's countries were experimenting with one or another form of decentralization. Since then, new or deepening reforms have been announced in more than two dozen countries. What do so many studies of so many real policy experiments have to say about decentralized competition and growth? Or about decentralization and fiscal policy?

Remarkably little, it turns out. The large majority of empirical studies of decentralization focus on public sector outputs such as school attendance rates, number of health visits and visitors, levels of public investment in primary services, and fiscal deficits. Relatively few examine economic growth, and fewer still focus on industrial policy success.

A few who do include Rodríguez-Posé and Bwire (2004), who find that devolution in Germany, India, Italy, Mexico, Spain, and the US has effects on economic growth that are usually insignificant, or else negative. Martínez-Vázquez and McNab's (2003) survey of over 120 studies finds mixed results on both the direct and indirect effects of decentralizing reforms on growth, with no clear pattern of evidence one way or the other. Feld, Baskaran and Schnellenbach (2008) find that, "Overall, the empirical evidence is rather inconclusive whether there is an effect at all."

In their study of Swiss federalism, Feld, Kirchgassner and Schaltegger (2004) find that matching grants (cooperative federalism) decrease economic performance, while tax competition (competitive federalism) improves the allocation of public funds, and hence growth in cantons. And cantonal fragmentation does not seem to affect GDP/capita. And Asatryan and Feld (2011) find no robust effects of fiscal federalism on growth in 23 OECD countries between 1975-2000. In sum, we do not know how, or indeed if, federal structures and decentralized power lead to higher or lower economic growth, nor if they improve the implementation of industrial policy. This is both odd and unfortunate.

This paper analyzes government failure and success, and how to promote success and avoid failure. We begin with decentralization's first-order effects, and when reform does and does not lead to government failure. We then consider other ways in which federal competition can indirectly support industrial policy.

2. Theory: First-order effects

When the evidence is unclear and contradictory, one reasonable response is to turn to theory for guidance. Theory can potentially help understand evidence such as this by elucidating the underlying mechanisms at work, and help us to distinguish more from less important evidence. But first we must distinguish between two different dimensions of federal competition: (i) first vs. second-order effects, and (ii) 'between' vs. 'within' competition. I use the term 'first-order effects' in the strict, technical sense: direct effects, or the first derivative of reform. By this I do not mean effects that are larger, more important, or somehow favored. Indeed, it is not unusual for the second-order (indirect) effects of a particular intervention to be far larger than its first-order effects.

For example, the first-order effects of untrammelled money creation, when an increasing quantity of money chases the same amount of goods, are inflation. But even hyperinflation, corrosive as it is, is less damaging than the social uprisings or political collapse that can ensue if excessive money creation is sustained. Consider, for example, the experience of Weimar Germany. But to understand second-order effects properly, it is important first to understand the first-order effects of reform, if only because how the direct effects evolve can strongly shape the indirect effects that follow.

What, then, do decentralizing reforms do? Their primary effects are to reorganize political authority, alter the relations of accountability, and change expenditure patterns across the state (Faguet 2012). They devolve resources and political authority from higher to lower levels of government that have their own democratic mandates and are substantially independent of the center within a given geographic and functional domain. The first-order effects that we should expect such a reform to have concern public sector efficiency, effectiveness, and the quality of public decision-making. Public policy and services might become better informed of local conditions, more responsive to local voters, or simply cheaper if unit costs fall. Any or all of these effects might also run in the opposite direction. But we have no reason to expect the reorganization of authority and expenditure to directly affect growth. Any effects on growth will come through the second-order effects of reform, as more efficient or effective public goods and services help the economy to grow faster. Any effects on

the success of industrial policy will come through improved public investments and better-quality decision making.

Secondly, most proponents of federal competition for industrial policy refer to 'between competition' – that is, competition between subnational units for investment, business activity, and skilled workers. Much of this activity might be better referred to as parallel experimentation, as municipalities and states only rarely compete for resources in a direct sense, but are more often “measured up” against one another indirectly.⁴ Another, more regular and probably more intense form of federal competition is 'within competition' – the competition for power that grants control over subnational resources via some form of subnational politics. This, as we shall see, is an important source of government failure, and thus merits close examination.

3. Analyzing government failure and success

How exactly does government failure work? Can it be avoided? Let us proceed inductively, exploiting natural variations in local government quality in a recent, notable case of radical decentralization reform: Bolivia. We first consider direct evidence of a very low and a very high-functioning municipal government, before stepping back to theorize about decentralization and the determinants of responsive, accountable governance. Consider first Viacha. When Bolivia decentralized in 1994, Viacha was the 13th largest municipality in the country. Located on the old road from La Paz to Oruro, it is was an industrial city with powerful cement, beer and brick and tile businesses connected to a large rural hinterland that stretched to Peru. Charagua, by contrast, was a small agricultural town lost in the enormous, semi-arid Chaco, with a huge rural catchment area measuring 72,000 km² – larger than Costa Rica or Holland and 2½ times the size of Belgium. This catchment area was sparsely populated by subsistence-farming Guaraní indigenous people, whose education was lacking and whose poverty was profound. Figure 1 places both on the map of Bolivia.

⁴ I am grateful to Tom Kenyon for this point.

Figure 1: Map of Bolivia with Viacha and Charagua indicated



source: US Central Intelligence Agency: Maps Released to the Public; downloaded from the University of Texas at Austin, Perry-Castañeda Library Map Collection (<http://www.lib.utexas.edu/maps>).

With its rich resource base, easy access to the professional and technical resources of La Paz, and comparatively low transportation costs, conventional theories of public management would have predicted that Viacha would have the better

municipal government. By contrast, Charagua, more than 5 hours by dirt road from the nearest city – roads which became impassable during the rainy season – lacking a resource base and trained professionals, and with a huge, poor rural area that the mayor could not physically reach during 4-5 months of the year, would seem destined for low-quality government. But in fact the opposite was true.

Viacha

Viacha's mayor systematically sabotaged accountability and public oversight. The municipal council was passive, ignorant, and unwilling to assume responsibility. Together, they produced a local government that was unresponsive, violent and corrupt. Some evidence for this includes: (1) Local government expanded its payroll by more than 100% without increasing its administrative ability or technical skills; (2) A grand municipal coliseum building was unfinished, and wildly over budget 12 years after breaking ground; (3) An infamous exploding sewerage projects saw politically connected contractors dig up existing pipes and replace them with faulty ones which subsequently exploded, throwing human waste up onto the sidewalks of the city, and leaving gaping craters in some of its principal streets; (4) A national audit charged the mayor with corruption and malfeasance.

Charagua

In Charagua, by contrast, local government was participatory and responsive, led by strong organizations of government produce high-quality policy outputs. Evidence for this includes: (1) The mayor topped a departmental ranking; (2) Despite huge growth in the local budget of 6,500% as a result of decentralization, operating costs were kept to only 4% of the total; (3) The same national government audits that damned Viacha praised Charagua; (4) Even where specific policy priorities were disputed, local testimony overwhelmingly concurred that local governments was honest and hard-working.

How can we explain these surprising differences? Figure 2 lays out a model of government effectiveness that shows how economic interests interact with civic organizations to produce a local politics that is open and competitive, or not. The model works like this.

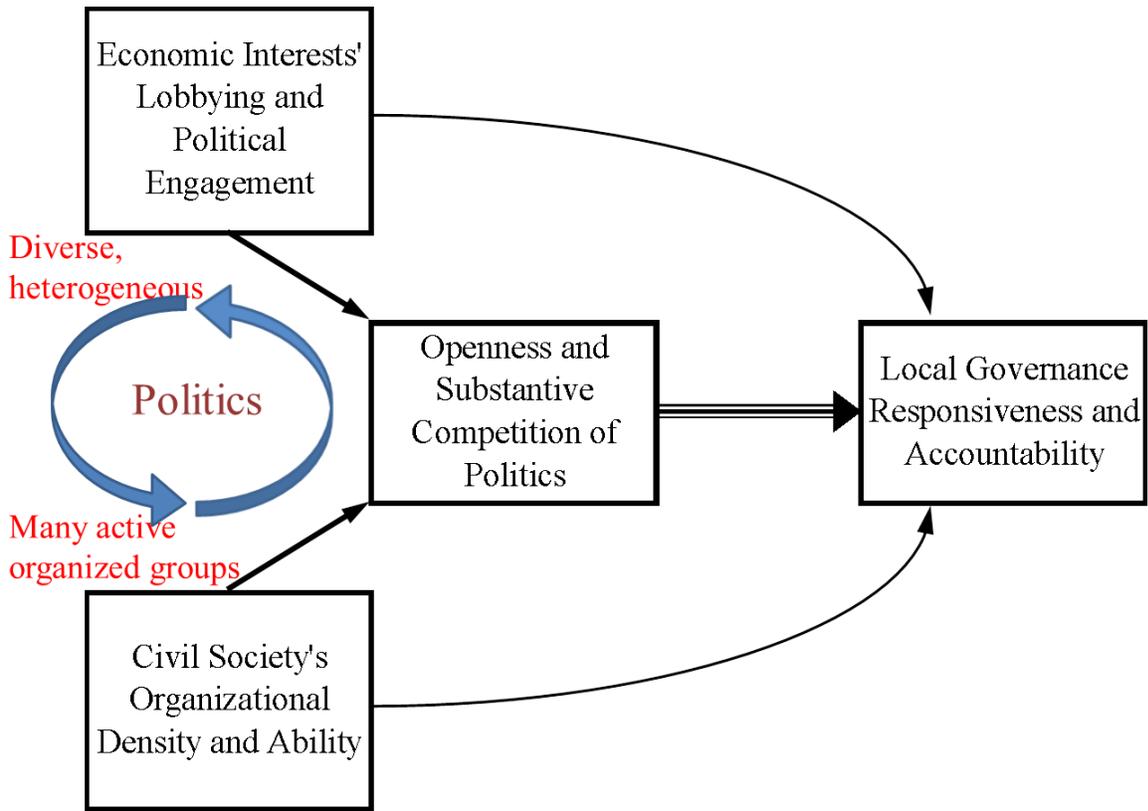
Our goal is to explain where government is responsive to local needs and accountable to voters, and where it is not. The deep study of our two case studies along with seven more, plus exhaustive analysis of a database containing all of Bolivia's municipalities, people, and territory, imply that the proximate cause of high-quality local government is an open and substantively competitive local politics. But open, competitive local politics is not an exogenous feature of any locality. It is not somehow given that politics in one place is open but in another place is closed. Rather, this is endogenously determined by the interaction of two key sets of actors: economic interests, and civic organizations.

The first set consists of businesses, landowners, and other important economic actors and organizations, and focuses on the way they lobby and fund political activity. Where economic interests are more diverse and heterogeneous, they will tend to have a wider array of interests, and will accordingly support a broader array of political parties and candidates. By contrast, where a single economic interest or organization is dominant, one political party will tend to benefit at the expense of all others.

Where civil society is concerned, it is a simple empirical regularity that some places are characterized by a highly organized, active civil society full of groups that intermediate between the individual and her government, and others are not. In the former, specific local needs and priorities are given stronger voice by virtue of being shared amongst many citizens and identified and voiced by their groups, which act as an important counterweight to the lobby power of firms. In the latter, citizens operate in a more atomized way, the "common-ness" of certain needs and wants is less often discovered, and the voice of society is much weaker in local affairs.

Where many active, organized civic groups interact with diverse, heterogeneous economic interests, politics will tend to be open and competitive, and the competition will center on real local needs and priorities as defined (differently) by both civic and economic actors. By contrast, where such interaction is missing, because economic interest is homogenous or society is unorganized, politics will tend to be closed, uncompetitive, and dominated by entrenched groups or interests. As a result, government will be far less responsive and accountable to voters that would otherwise be the case. Figure 2 illustrates these relationships graphically.

Figure 2: A model of government effectiveness



Both corruption and ineptitude in Viacha, and Charagua’s transparent, responsive, accountable government can be explained using the same framework. In **Viacha**, the dominant economic interest was the CBN brewery, which became the monopsonistic provider of finance to the entire political system. This company acted with fiercely partisan aggression to support its own political party, the UCS, and actively undermine or corrupt opposition parties in order to quell political competition, remove electoral challenges, and thoroughly dominate the political system. In this case, "its own party" is not a figure of speech, but is rather descriptively correct. For the CBN brewery and the UCS political party were both founded by the same man, Max Fernandez, who ran them as a single family enterprise offering products in the politics and beer markets. The brewery put its entire distribution network, trucking beer to the smallest towns and villages throughout the countryside, at the service of the party. Political rallies were manned by workers in overalls in the particular shade of blue that both brewery and party shared, with the beer logo emblazoned on the front and the political logo

emblazoned on the back. Huge banners above the stage read "Drink Paceaña beer", and underneath, "Vote UCS".

The brewery's efforts were not only positive in nature, but negative as well. I was told in detail by both sides of the transaction that the local CBN chief paid the head of the local MIR political party to remove his top political candidate, an elderly doctor known by most urban Viacheños, and replace him with a politician known to be corrupt. "But he's corrupt," the MIR leader objected. "Yes exactly!" roared the beer boss. "You've got it. And if you don't do it not only you won't get the money, but I'll screw you like you've never been screwed before!" And so the cash was paid and the deal was sealed.

And so local politics became stagnant and uncompetitive, with no substantive choice, where parties competed on small gift giving (e.g. blue plastic buckets). During a period where turnouts throughout Bolivia were more than doubling, in Viacha voter apathy grew and turnouts plummeted some 40%. One might hope that civil society might contract such a negative dynamic. But in Viacha, society was doubly divided against itself: "white, European" urbanites against indigenous peasant rural farmers; and rural peasants of the Machacas region, who retained pre-Columbian forms of social organization, against rural peasants from regions closer to the city, where peasant unions prevailed. As a result, Viachan society suffered episodic outburst of violence, endemic mistrust, and widespread collective action failures. The ultimate result of this governance system was a local municipal governments that was unresponsive, unaccountable, untransparent, and corrupt.

In Charagua, by contrast, the most important economic interests were cattle ranchers, by nature independent family-run enterprises, who were far more heterogeneous collectively than Viacha's monolithic brewery, and who supported a wider range of political parties. As a result, Charaguan politics was open, competitive, and featured a high degree of political entrepreneurialism. The best example of the last is when the MIR political party approached Guaraní leaders and proposed an alliance whereby the two sides agreed a political platform, the party adopted any candidate of the Guaraníes' selection as its own, and Guaraní villages voted for the MIR en masse.

Such strategy could only work because local civil society – the third element in our model – was highly structured and coherent in the form of the Guaraní people's

assembly (APG in Spanish), which built upwardly stratified layers of representation upon the traditional mechanisms of community self-government in the Guaraní world, such that there were APG representatives at the village, municipal, provincial, departmental, and national levels. The presence of the APG meant the MIR found a credible, sophisticated, legitimate interlocutor with whom to negotiate – an interlocutor who could keep its side of the bargain and get out the rural vote for the first time in living history. As a result, the MIR went from the electoral wilderness in Charagua to victory, strode confidently into town hall, and took over. The government that resulted was transparent, responsive, and accountable, pushing through a huge program of social investment in rural areas such as Guaraní villagers had never seen before.

4. Transformation of Governance: Within and Between Competition

Such were the effects of strikingly different local dynamics on a common institutional shock in Bolivia, where “within competition” of very different natures produced very different outcomes. The following 13 years saw dramatic changes in both municipalities, not least because “within competition” combined with “between competition” to accelerate changes that in Viacha ended up transforming government, and in Charagua deepened participation and transparency.

I returned to Viacha 13 years later to find a corrupt, obtuse local government transformed into an open, transparent, responsive administration. Some evidence to support this claim includes:

- All 63 rural communities in the municipality now have electricity and potable water;
- Over 70% of schools have internet;
- The mayor provides quarterly public reports, weekly reports to the local oversight committee;
- Spending plans have been devolved down to the district/community level;
- Three successive national audits praised municipal performance; and
- A UNDP report ranked Viacha in the top sixth of all municipalities in Bolivia.

How did this change come about? The key came when the factor distorting Viachan politics – the CBN bottling plant – was closed down by its new owner, the

Argentine Quilmes brewery, for purely business-related reasons. The removal of this exogenous constraint on local political activity permitted the gradual, accelerating ascent of civil society in Viacha over the following decade. Civic associations grew in size, integrity, and ability. And then, when a modernizing candidate promising transparency and efficiency emerged, Viacha's urban and rural civic groups were able to coalesce around him, and he was easily elected mayor. The broad and striking changes that he put into place in town hall led to the transformation of government processes and outputs described above. Throughout this period, political competition combined with the example of nearby localities to drive change. After a long climb out of the hole of government failure, voters had learned the costs of conflict and paralysis and did not want to fall back in.

Thirteen years later, the changes in Charagua were less dramatic but nonetheless impressive. Local government had improved further, especially in terms of participation and transparency, which had deepened considerably. Some evidence to support these claims include:

- All rural communities now had schools, health posts, and electricity;
- Budgeting and planning were devolved to the district/community level;
- The mayor provides quarterly public reports on municipal works and the budget;
- Communities manage budgets and projects directly; and
- A UNDP report ranked Charagua third-best nationwide.

How did this change come about? One key factor was the approval of the national Law of Citizen Associations, which liberalized what sorts of organizations could register for elections, allowing the APG to compete directly rather than through an established party. There ensued an APG-MAS (President Evo Morales' *Movimiento al Socialismo* party) coalition, which brought political stability to Charagua over five years, permitting longer-term planning and public investments. Thirdly, ranchers both individually and (especially) through their association chose to work with the Guarani-dominated local government, rather than attempting to resist or undermine it, as happened elsewhere in the country. Throughout this happy period, it was clear that in a context of political competition plus high participation, the experience of good

government led to an endogenous rise in local voters' standards and expectations for what local government could and should do. This in turn coaxed ever-increasing levels of performance from successive administrations, who similarly internalized voters' rising expectations into their political calculations. Responsible, flexible, accountable government was the result.

Hence government is successful when our model (see figure 2) operates as it should – in particular when economic interests and civic groups interact through politics to reveal, debate, and trade off their competing interests, and so fashion policy. By contrast, government failure looms when homogeneous economic interests monopolize the supply of political finance, or when civil society is atomized and unorganized or inert. The model's ability to explain the changes in government performance in both places over 13 years, by analyzing the interactions between economic actors and civic groups, further confirms its explanatory power.

5. Second-order effects

These, then, are the determinants of government failure, but also of government success in the form of accountable, responsive governance. These first-order effects of federal reforms can have second-order effects on industrial policy to the extent that higher-quality subnational governments are more likely to choose reasonable industrial policies and implement them well. And government failure must be avoided if industrial policy is to avoid falling prey to the crippling threats of capture and corruption, or plain incompetence.

Do federalizing reforms have other second-order effects conducive to successful industrial policy? Myerson (2013) draws on the economic analysis of oligopolies to answer affirmatively. A well-ordered federal system can significantly increase political competition, providing strong incentives for higher-quality policy making and tighter reins of accountability to the governed, in the following interrelated but conceptually distinct ways:

1. *Alternative routes for entering national politics.* If the only route is via national parties, parliamentary leaders can keep out challengers, oligopolize power, and raise their corruption-price. Policy becomes less responsive to citizens' wishes or to

the requirements of economic growth. Federalism can provide alternative routes into national politics through provincial and local governments, thus increasing total competition and so the quality and probity of a nation's policymaking.

2. *New opportunities for independently elected politicians to demonstrate competence.* The possibility that successful local officials will advance to higher levels of power in a federal system increases the elasticity of political demand for politicians at each level below the top, and thus increases their competitive incentives to offer better public services.
3. *Greater effort by subnational politicians to win popular support,* which strengthens national parties competitively in national elections. This mechanism works in both directions, hence...
4. *National party sponsorship of local challengers can raise competition in local elections,* and so improve the quality of local policy-making.

Weingast (2013) makes a deeper point concerning the underlying distribution of power in a society. All successful societies limit the stakes of power by restricting the scope of political authority to act against the interests of citizens, especially the powerful. There are two broad ways of doing so: General rules or Special privileges. General rules, such as the general incorporation of limited liability companies, are usually run administratively and are open to all qualifying adults. Special privileges, such as special incorporation of limited liability companies, usually require acts of parliaments and typically confer rights and privileges to individuals favored by the state. General rules produce open access regimes, which characterize developed countries. Special privileges produce limited access regimes, which characterize developing countries. They limit access to markets and organizational forms privileged by law in order to create and distribute rents to favored individuals and groups. As a result, such economies suffer higher informality, lower investment and innovation, and lower growth.

How would industrial policy fare under each? It is straightforward to see that industrial policy in a limited access regime will quickly degenerate into clientelism, rent-seeking, and capture. The toolbox of industrial policy includes some very powerful tools with sector-wide, and even economy-wide, effects, such as tariffs, subsidies, intellectual property rules, and the exchange rate. Allowing governments to manipulate such tools

in a context designed to create and distribute rents to favored groups seems destined to distort resource allocation for the sake of factional gain rather than broad economic development. Even if capture is avoided, the power of industrial policy will be far lower in markets where access is limited and competition is lower. By contrast, open access regimes are designed to make markets and legal privileges accessible to most adults. Such markets are by construction more competitive, innovative, and efficient. They will tend to respond more powerfully to industrial policies that are, in turn, less likely to become distorted.

What does all of this have to do with federalism? Federalism and decentralization are incentive-compatible ways to limit the power of government by dividing this power up amongst different levels, rather than concentrating it in the hands of a single authority. The multiple tiers of government that federalism creates increase the chances that a citizen's rights will be protected by one or another level of government. By reducing the discretion of (central) government, federalism reduces the power of politicians to appropriate citizens' property, and protects citizens from abuses of power.

Decentralization and federalism are thus an alternative to limited access regimes for limiting the stakes of power and restricting the scope of political authority over citizens' rights, assets, and economic activity. In developing countries where power-limiting institutions are scarce, federalism provides an incentive-compatible way to limit the power of central (and regional and local) authorities. It can protect the interests of the powerful, and along the way for all citizens, while simultaneously building a culture of democratic practice throughout the length and breadth of a country. Developing countries can migrate to open-access regimes, with their greater dynamism and faster growth, while continuing to safeguard the interests of elites. Although seldom acknowledged, this is the crux of the argument in favor of federal industrial policy.

6. Conclusions

Industrial policy hovers in the intellectual space between market failure and government failure. Can subnational competition overcome government failure and make industrial policy more effective? The empirical evidence is limited and

inconclusive. This paper analyzed the first and second-order effects of federalist reforms, and then distinguished two types of federal competition ‘between’ vs. ‘within’-competition. Although most commentators refer to the latter, the former is probably more important. Federalism’s first-order effects are on public sector efficiency, effectiveness, and the quality of public decision-making – that is to say, government failure or success. It only affects industrial policy indirectly, through this channel. When diverse economic interests and civic groups interact through politics to reveal, debate, and trade off their competing interests, and so fashion policy, government will tend to be responsive and accountable. Where economic interests are homogeneous or civil society is inert, government failure looms. All of this refers to ‘within’ competition. Further second-order effects of federalism include increasing the level of competition in a political system, and limiting the power of government against citizens in ways that make democracy compatible with open access regimes. Industrial policy is far more likely to succeed in the latter due to greater economic participation and dynamism. This is the crux of the argument in favor of federal industrial policy.

These arguments imply that federalist reforms can contribute to the institutional changes that accompany broad historical transitions to increasing wealth and freedom. The study of such transitions has seen a remarkable resurgence in recent years. Regardless of whether development transitions are conceived of as leading to open-access societies and economies (North, Wallis and Weingast 2009), or inclusive institutions (Acemoglu and Robinson 2012), theorists agree that they consist of a complex of interdependent changes across government, the economy and social relations (Brett 2009).

Many of these changes, such as technical upgrading in the productive sector, are not susceptible to federalism. For others, such as infrastructure expansion and human capital formation, federalism can be a useful contributory measure. But for some of the most important transformations involving governance and the exercise of power, such as improving public accountability, increasing political competition, decreasing corruption, limiting government power, and enhancing political and economic stability, decentralization and federalism are centrally implicated.

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