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*Institutional perspectives on democracy and federalism: some comments on Argentina and Australia*

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**INSTITUTIONAL PERSPECTIVES  
ON DEMOCRACY AND  
FEDERALISM: SOME  
COMMENTS ON ARGENTINA  
AND AUSTRALIA**

**Por Patricia A. Saporiti**

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# **INSTITUTIONAL PERSPECTIVES ON DEMOCRACY AND FEDERALISM: SOME COMMENTS ON ARGENTINA AND AUSTRALIA**

Patricia A. Saporiti

## **Resumen**

Citizens in stable democracies value democracy and take costly actions to defend its institutions. The design of optimal political institutions and a governance structure becomes important and the rule of law is a central feature of limited government. Inter temporal commitment of government is crucial and successful democracies satisfy the limit condition. There is a coordination dilemma about the appropriate limits on the state. Therefore, an alternative strategy is to initiate democracy at the local level, since federal decentralization of authority places limits on the center.

This paper analyses democracy, democratic stability and the role of political parties in Argentina and Australia from 1880 to 1940s. The states' ability to coordinate is critical to confront the central government opportunism. The experience of Australia and Argentina reveals that different institutional environments have consequences for social consensus and collective action. The paper describes the evolution of federalism in both countries, in particular focusing in the imposition of income tax.



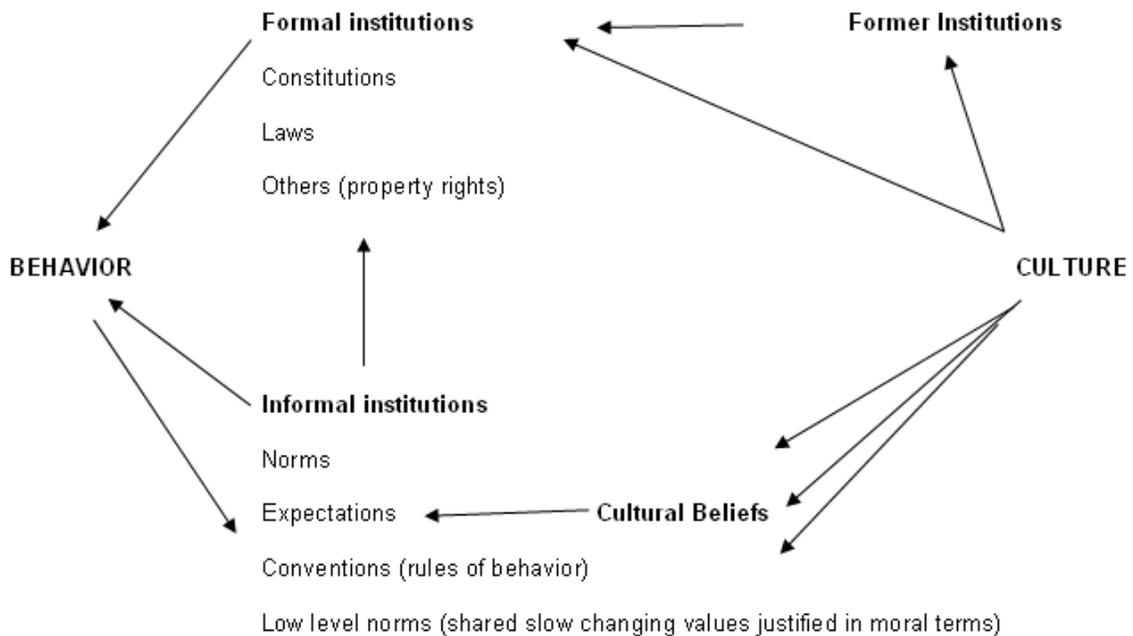
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## I. Introduction

Douglas North<sup>1</sup> has defined **institutions** as “the humanly devised constraints that structure political, economic and social interaction”, including informal constraints (such as sanctions, taboos, customs, traditions, and codes of conduct) and formal ones (constitutions, laws, property rights), created to provide order and reduce uncertainty in transactions. They structure human interaction in an uncertain world. We can think of institutions as behavior incentives. They provide coordination, diminish conflicts and reinforce trust between parties. Institutions may either be self-enforced or may need specialized enforcement.

**Fig 1 Behavior, culture and institutions**



<sup>1</sup> North, “Institutions”, Journal of Economic Perspectives 5(1), 1991.



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Institutions evolve incrementally and are subject to path dependence. In particular, change in informal institutions can be slow and unpredictable. North<sup>2</sup> argues that beliefs determine behavior and, unlike preferences, they involve the way people learn, update and model the world around them. In that sense, knowledge of other people's actions and beliefs is essential for the construction of mental models. Beliefs influence institutions as cultural learning provides shared explanations. Greif<sup>3</sup> defines **cultural beliefs** as "the ideas and thoughts common to several individuals that govern interaction and differ from knowledge in that they are not empirically discovered or analytically proved". They are important in the organization of society. "Unlike strategies, cultural beliefs are qualities of individuals in the sense that were crystallized with respect to a specific game affect decisions in historically subsequent strategic situations. **Past cultural beliefs provide focal points and coordinate expectations**, thereby influencing equilibrium selection and society's enforcement institutions". In the long run, reflecting an increase in the stock of knowledge, the rules of the game can change endogenously by establishing organizations. Meanwhile, cultural beliefs determined the costs and benefits of various actions and hence efficiency, and are sufficient to explain diverse trajectories of societal organization. **One of the most important conclusions is that expectations about expectations are difficult to alter<sup>4</sup>, and thus cultural beliefs can make Pareto inferior institutions and outcomes self-enforcing.** This argument illuminates one of the sources of the **institutional path dependence**, because **the capacity of societal organization to change is function of its own history**, and although efficient choices may lead to different institutions, transplantation may be disastrous<sup>5</sup>, formal institutions may

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<sup>2</sup>North "Economics and Cognitive Science", Working Paper, Washington University at St. Louis, 1996

<sup>3</sup> Greif, "Cultural Beliefs and the Organization of Society", *Journal of Political Economy* 102(5) (1994), p.915

<sup>4</sup> Carmichael and MacLeod link gift giving with the evolution of cooperation, but their most interesting conclusion is that **social customs exist, individuals are subject to cultural programming**. The authors justify the point as part of **evolution of culture**, as long as there's a sufficiently complex environment, which calls for sophisticated patterns of behavior, and changes of the environment that are sufficiently slow. Nevertheless we can ask if people (as a unit) can learn from the mistakes if given that population continually changes (example massive immigrations flows, so important in settler countries)

<sup>5</sup> European powers brought their respective institutions to the "new world". Napoleon exported the legal system to Spain, and it was transplanted to Latin America, while the English common



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change quickly, but informal constraints not.

## II. Institutional Perspectives on Democracy and Federalism

Djankov et al (2003)<sup>6</sup> assume that the role of government may differ between countries in terms of democracy-dictatorship, ownership of industries, regulation, and internal structure (centralism-federalism). They focus on the institutional possibility frontier for a society to illustrate the tradeoff between the dangers of dictatorship and disorder that institutions try to control. Institutions may evolve from democratic pressures, from the rent seekers influence, from negotiation among elite members or from an evolutionary process. The authors emphasize the **concept of civic capital** as a central determinant of the institutional possibility frontier. It is worth mentioning that civic capital is a broader concept than social capital.

The following section will focus on the institutional aspects with respect to democracy and internal structure of the government, with some comments on Argentina and Australia.

### i) Democracy and democratic stability

Although democracy is perhaps the most celebrated institutional mean to create political accountability, most new democracies fail to survive, especially in developing countries<sup>7</sup>. Weingast (1997)<sup>8</sup> focuses on the problem of **democratic stability and the rule of law** using a simple game-theoretic model of the stability of "limited government" (with universalistic laws, not discretionary political power). Democratic survival requires that politically rational officials observe limits on their behavior; so democracy is a form of limited government. He suggests that understanding democratic stability requires the **analysis of institutions, citizen values and behavior**,

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law tradition was transplanted to Australia. See Djankov, Glaeser, La Porta, Lopez-de-Silanes and Shleifer, "The New Comparative Economics", *Journal of Comparative Economics* 31(4), December 2003

<sup>6</sup> Djankov, Glaeser, La Porta, Lopez-de-Silanes and Shleifer, "The New Comparative Economics", *Journal of Comparative Economics* 31(4), December 2003

<sup>7</sup> Iaryczower, Matias, Sebastián Saiegh y Mariano Tommasi "Coming Together: The Industrial Organization Of Federalism", Centro de Estudios para el Desarrollo Institucional (CEDI) Fundación Gobierno & Sociedad & Universidad de San Andrés, mimeo

<sup>8</sup> Weingast, "The Political Foundations of Democracy and the Rule of Law", *American Political Science Review* 91(2), June 1997, p. 245-263.



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**and elite behavior.** The author focuses on the **rule of law** as a central feature of **limited government** with self enforcing limits on political officials, composed of institutional restrictions, but also attitudes and reactions of citizens, as expectations of the citizens must constrain the rulers. Citizens in stable democracies must value democracy and also will take costly actions to defend its institutions. It is in part a coordination dilemma among citizens (and elites) about the appropriate limits of the state. Successful self enforcing pacts resolve the social coordination problem confronting elites and citizens. The most natural equilibrium of the game is coordination failure due to different economic positions, beliefs and mental models, as well as information. The challenge is the design of such **political institutions** that credibly (and in a self-enforcing way) commit to limit future political discretion, and that requires a **governance structure**, beginning with the Constitution. Therefore, the **intertemporal government’s commitment** is crucial. Successful democracies satisfy the limit condition<sup>9</sup>, but an alternative strategy is to initiate democracy at the local level, because the federal decentralization of authority places limits on the center.

## ii) Internal structure of the government

The internal structure of the government may range from centralism to federalism, the most fundamental feature of federalism being decentralization. A federal political system<sup>10</sup> has a hierarchy of governments, each with a determined scope of authority and its respective autonomies institutionalized in a self-enforcing way. Federalism restricts the discretion of the center<sup>11</sup>, preventing interest groups and distributional coalitions, limiting in their influence over lower-level governments<sup>12</sup>.

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<sup>9</sup> Weingast, “Second Generation Fiscal Federalism: Implications for Decentralized Democratic Governance and Economic Development,” Working Paper, Hoover Institution, Stanford University, May 2006.

<sup>10</sup> Riker, 1964 en Weingast, “The Economic Role Of Political Institutions: Market-Preserving Federalism And Economic Development”, in Journal of Law, Economics and Organization, Vol 1, N° 1, April 1995, pp 1-31

<sup>11</sup> Tiebout, 1956; Oates, 1972 in Weingast, “Second Generation Fiscal Federalism: Implications for Decentralized Democratic Governance and Economic Development,” Working Paper, Hoover Institution, Stanford University, May 2006

<sup>12</sup> Riker, 1964 in Weingast, “Second Generation Fiscal Federalism: Implications for Decentralized Democratic Governance and Economic Development,” Working Paper, Hoover Institution, Stanford University, May 2006.

Distinct economic perspectives constitute the theoretical **literature on federalism**. We can explain federalism from an institutional perspective, applying the theory of incomplete contracts.

1. The **public goods theory** of fiscal federalism focuses on its effect on efficiency. If a hierarchy of spatially<sup>13</sup> arranged public goods is established, their optimal provision requires a federalized public sector in which the hierarchy of those goods corresponds with the hierarchy of the governance structures. Following Musgrave<sup>14</sup>, the redistributive function should be assigned to the national governments whereas the allocative function should be shared with the sub-national governments.
2. The **organizational costs** theory of federalism recognizes the cost constraints of the assignment problem. It introduces an explicit objective function of the governments in terms of power (re-election). Those governments will provide public goods in accordance with the preferences of the voters, at minimum possible cost to the taxpayers.
3. **The public choice** perspective on federalism affirms that in the absence of appropriate institutional constraints, the natural tendency of a government is to use its power over taxation to exploit the electors. This approach favors fiscal federalism because the multiplicity of governments is helpful in restricting the power of each level of government and in increasing the welfare of the voters.
4. The **Theory of Incomplete Contracts** is based fundamentally on the need to transact business among separate entities, none of which can foresee and predict the future completely<sup>15</sup>. The governance structure is conducted under

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<sup>13</sup> Breton, 1965 in Grewal, Bhajan and Sheehan (2003): The Evolution of Constitutional Federalism in Australia: An Incomplete Contracts Approach, CSES Working Paper No. 22. Centre for Strategic Economic Studies Victoria University of Technology

<sup>14</sup> Musgrave, 1959 in Grewal, and Sheehan The Evolution of Constitutional Federalism in Australia: An Incomplete Contracts Approach, CSES Working Paper No. 22. Centre for Strategic Economic Studies Victoria University of Technology, 2003

<sup>15</sup> Williamson, 1996; Hart, 1995; Sheehan, 2001 in Grewal, 2003 op.cit.



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separate, incomplete and implicit contracts between national and subnational governments<sup>16</sup>.

Ideally, revenue sharing (through unconditional grants from national to subnational governments) provides an efficient mechanism for combining the benefits of centralized taxation and decentralized public expenditure<sup>17</sup>. Traditionally, national governments are assumed to act benignly. In the context of incomplete contracts, governments look forward to a position of power over their partners, and revenue sharing is a powerful instrument of intergovernmental control. The more important issue in the intergovernmental competition is the overall financial dependence of one level of government over another (not only conditional transfers). The distribution of powers in a federation evolves over time, influenced by exogenous and endogenous forces of intergovernmental competition. Any reform of a governance structure must consider the dynamics of the process.

#### a) Federal Governance Structure<sup>18</sup>

Incomplete governmental contracts, due to bounded rationality, may be handled by some governance structures. **Federal governance structures include a) policies of the central government jurisdiction, b) the structure for the federal government, and c) the process by which central and provincial governments decide changes in the first two.** Those structures allow some benefits of cooperation, although some transaction costs exist. On the one hand, a limited central government might forego (efficient) transactions conducive to the internalization of externalities and the cooperation to achieve economies of scale. On the other hand, delegation will be subject to Madison's Dilemma<sup>19</sup>. Subsets of provinces will behave opportunistically

<sup>16</sup> Those contracts create opportunities and incentives for intergovernmental fight over the scope of legislative competence. For example, intergovernmental financial transfers are an important feature of federal finance in most countries that have more than one level of government.

<sup>17</sup> Oates, 1999, in Grewal, and Sheehan 2003 op.cit.

<sup>18</sup> Iaryczower, Saiegh and Tommasi "Coming Together: The Industrial Organization Of Federalism", Centro de Estudios para el Desarrollo Institucional (CEDI) Fundación Gobierno & Sociedad & Universidad de San Andrés, mimeo

<sup>19</sup> Kiewiet and Mc Cubbins, 1991, cited in Iaryczower, Saiegh and Tommasi "Coming Together: The Industrial Organization Of Federalism", Centro de Estudios para el Desarrollo Institucional (CEDI) Fundación Gobierno & Sociedad & Universidad de San Andrés, mimeo



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and redistribute resources towards themselves, eventually generating exploitation of minorities. Avoidance of opportunism may be pursued by horizontal fragmentation of power at the national level (i.e. separation of three powers) and by appropriate representation of regional interests in the national legislature (i.e. through the strength of its committee system, voting mechanisms, etc.). The degree of unification and the national orientation of political parties may take a role in a broader governance structure, and well as unions or business organizations. Riker listed the two fundamental **dilemmas of federalism**. (Dilemma 1. Prevent the national government from destroying federalism by overawing its constituent states; Dilemma 2. Prevent the constituent states from undermining federalism by failures to cooperate). de Figuereido and Weingast present a **model of self-enforcing federalism**<sup>20</sup>, for stable federations to solve them. The model emphasizes that the benefits from federalism must be sufficiently large for both the center and the states. Furthermore, the federal government must have enough enforcement resources, and local states must coordinate on punishment strategies. Since constitutions are not externally enforced, the resolution of the dilemmas requires that the rules defining a federation be **self-enforcing for political officials at all levels of government**. The states' ability to coordinate is critical to resolve the dilemma of central government encroachment and opportunism. The creation of a **constitution** may generate a **focal point** that coordinates state reactions against a central government violating the rules. De Figuereido and Weingast suggest that a "culture of federalism" or "federal culture" sustaining a federation is an endogenous outcome and, consequently, a product of the design stage.

#### b) First and Second Generation Fiscal Federalism<sup>21</sup>

The fiscal interest approach shows that the tax system affects subnational government policymaking. First generation fiscal federalism analyses intergovernmental transfers and focus on equity considerations rather than on their effect on growth. On the one hand, horizontal imbalances arise because regional economies differ. On the other hand, vertical imbalances arise when the central government collects taxes more easily

<sup>20</sup> de Figuereido Rui J. P. and Weingast "Self-Enforcing Federalism" in n Journal of Law Economics and Organization Vol 21, N1. 2005

<sup>21</sup> Weingast, "Second Generation Fiscal Federalism: Implications for Decentralized Democratic Governance and Economic Development," Working Paper, Hoover Institution, Stanford University, May 2006.



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and at lower economic cost and when it preempts revenue sources that subnational governments might use<sup>22</sup>. **Transfers are not incentive-neutral**, they may be weakly related to local growth, and may induce corruption and rent-seeking. Common pool problem of budgets may appear<sup>23</sup>. In that sense, representation of subnational levels in a national senate allows to pursue their collective interest of sub-national governments. The benevolent attitude of the center cannot be taken for granted. Local revenue collection helps maintain federalism and local policy independence because it increases citizens’ incentives to monitor their taxes, while helping local governments defend their policy independence. First and Second Generation Fiscal Federalism approaches are complementary. **Second Generation Fiscal Federalism assumes that public officials have goals (e.g. reelection) that often systematically diverge from maximizing citizen welfare.**

### c) Market-Preserving Federalism

The concept of Market-Preserving Federalism<sup>24</sup> requires a set of conditions on the allocation of authorities and responsibilities among different levels of government:

1. A *hierarchy* of governments with a *delineated scope of authority* so that each one is autonomous in its own sphere of authority.
2. Primary *authority over the economy* of the subnational governments within their jurisdictions.
3. Central government authority to police the *common market* and to ensure the mobility of goods and factors.
4. All governments *hard budget constraints*, otherwise<sup>25</sup> subnational governments have a reduced (or no) fiscal incentive to make prudent financial decisions.

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<sup>22</sup> McLure 1993 in Weingast, 2006 op. cit.

<sup>23</sup> Jones, Sanguinetti, and Tommasi 1999, Stein 1998, and Wiener 2003 in Weingast, 2006 op. cit..

<sup>24</sup> Montinola, Gabriella Yingyi Qian, and Barry R. Weingast (1995) “Federalism, Chinese Style: The Political

Basis for Economic Success in China”, in World Politics, October 1995, 48(1), pp. 50-81

<sup>25</sup> A soft budget constraint arises in two ways: when the central government explicitly bailout subnational governments in fiscal distress and when it (or the central bank) provide forgivable loans to finance subnational government deficit



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5. *Institutionalized degree of durability* in the allocation of authority and responsibility.

The most important effect of market-preserving federalism is the induced competition among jurisdictions, so:

1. No government has a monopoly of regulatory authority over the entire economy.
2. Competition among jurisdictions extends to factors of production.
3. Local governments can go bankrupt, so they face incentives for proper fiscal management.
4. Market-Preserving Federalism provides the political foundations for markets.

Weingast<sup>26</sup> focuses on the *market-preserving federalism*, because it restricts central economic policy-making and, promoting self-enforcing restrictions, historically underpinned rapid economic development (18<sup>th</sup> century England and 19<sup>th</sup> century US, and modern China). Market-preserving federalism limits the exercise of corruption, predation, and rent-seeking by all levels of government<sup>27</sup>, placing **limits on systems of patronage**.

Ideally democracy must satisfy the **limit condition**, so citizens will enjoy a wide range of rights and public goods and services by virtue of citizenship, not because of their political relationship with those in power. If the delivery of basic local public goods and services depends on whom citizens vote, the regime restricts citizen ability to influence public policies. Such strategy can be analyzed as a patron-clientele exchange system, a partially reciprocal but asymmetrical mechanism of authoritarian social control rather than a mechanism of citizen choice. Patrons can create relationships with clientele even if the latter are worse off on average from the relationship. This "**tragic**

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<sup>26</sup> Weingast, "The Economic Role Of Political Institutions: Market-Preserving Federalism And Economic Development", in Journal of Law, Economics and Organization, Vol 1, N° 1, April 1995, pp 1-31

<sup>27</sup> Weingast, "Second Generation Fiscal Federalism: Implications for Decentralized Democratic Governance and Economic Development," Working Paper, Hoover Institution, Stanford University, May 2006



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**brilliance mechanism**<sup>28</sup> represents pathology of both democracy and federalism, by giving central governments incentives to create highly centralized federalism. In that sense, patrons will have greater discretion over policy benefits, compromising the conditions of market-preserving federalism, and creating greater scope of political discretion. That's why countries that use this mechanism do not satisfy the limit condition.

### III. Some References on Argentina and Australia

#### i) Democracy and Democratic Stability. Role of Political Parties <sup>29</sup>

Duncan and Fogarty<sup>30</sup> argue that politics in Argentina from 1880 to 1930s were mostly fought over procedure, not policy. The rise of the Radical Party in the 1880s was similar to the rise of the contemporary Australian Labor Party. Although the Radical Party attracted great electoral support, it never closely identified itself with a sectional base, delaying political reform. In 1916 such an "electorally" popular party with no administrative experience or political compromise took office. In the 20s, the broad based party system with unitary structure of government faced little internal opposition to allocate resources in favor of the continued development of the external sector, perhaps thus explaining its relatively higher growth rate compared with Australia. The disadvantages become evident later. Under the Argentine Constitution, the president was empowered to intervene in provinces, and the radicals limited any representative opposition through presidential intervention and direct presidential patronage. Regarding politics, all the voters are generally categorized according to their

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<sup>28</sup> "Tragic in that they force citizens to accept corruption, low levels of government service, and inefficient policies; brilliant in that they induce citizens not only to accept these features, but to play an active role in maintaining the system. The "tragic brilliance" of one-party dominant systems lies in that the party employs a complex system of rewards and punishments that lead citizens to actively support the party, even if reluctantly". See Diaz-Cayeros, Magaloni and Weingast, "Tragic Brilliance: Equilibrium Party Hegemony in Mexico," Working Paper, Hoover Institution, Stanford University, February 2006.

<sup>29</sup> Duncan and Fogarty *Australia and Argentina. On parallel paths*, Melbourne University Press. 1984

<sup>30</sup> (ex. How to reconcile the institutions and conventions that had served to establish order in the second half of the nineteenth century with the changed society of the twentieth century that emerged as a result of expansion; basic political rights, popular leadership, conservatives' fears of a return to the illiberal era of the mob).



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preferences, with a one-dimensional political spectrum (liberal-minded people on the left and conservatives on the right)<sup>31</sup>. Nevertheless, Argentinean bigger political parties have historically avoided being closely limited within a sectional base. Then, without a tradition of loyal opposition, the country remained subject to winner-take-all politics.

Instead, **Australia**'s responses to the 1890 era of confusion were politically valuable as the country established the conventions to gradually integrate the interest of conflicting economic sectors. The crash highlighted the question of income distribution, though the debate over free trade and protectionism was important. That **was the genesis of a two party system that divided along the lines of capital and labor**. The labor movement developed into a **formidable and loyal opposition** with the establishment of the Australian Labor Party. New rules of the game to decide the distribution of income were established and the appeal of patronage networks reduced. The redefining of Australian politics around sectionally representative parties took place. The Federation added to the checks as states remained naturally suspicious of the new federal government. The Federation was resistant to quick changes and did not suffer the impact of abrupt political renovation.

## **ii) Internal Structure of the Government. Evolution of Federalism in Argentina and Australia**

The states' ability to coordinate is critical to confront the central government opportunism. Only in a federal culture the creation of a constitution generates a focal point that coordinates state reactions against a central government violating the rules. Applying Weingast<sup>32</sup> analysis of democratic stability to federal governance structures, we can argue that not only formal institutions, but **citizen values and behavior, and elite behavior** will support the federal governance structure. The different institutional environments in **Australia and Argentina have consequences in the evolution of**

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<sup>31</sup> If we suspect that an individual citizen votes for the candidate who is "closest" to him or her in regard to policy, the location model suggests that candidates will try to locate themselves toward the center of the spectrum, so they will try to argue that they are moderate, and actually behave this way.

<sup>32</sup> Weingast, "The Political Foundations of Democracy and the Rule of Law", *American Political Science Review* 91(2), June 1997, p. 245-263.



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**federalism** although both countries **have increased the role of central government through the twentieth century** as the result of weak federal governance structures.

The formally federal Constitution (and its successive modifications) was enacted in **Argentina** in 1853. Its design was inspired on the U.S. Constitution and established that all the powers that were not explicitly delegated by the provinces to the national government remained at the provinces disposal. It also gave the federal government the power to intervene in the provinces’ territory. The scope of action reserved for the central government, was meant to be very limited. After some struggle, national unification was achieved and the practice of the federal intervention grew, fueling the economic growth, at the expense of expanding the role of the federal government.

Until 1890 Argentina maintained a balance of power between the different levels of government and factions, and the practices of restrictive electoral participation and federal intervention were usual. The federal government and the provinces had their own sources of revenue, taxes on foreign trade the former and internal taxes, the latter. During the mid-1880s, sub-national states increased their public debts and many provincial banks issued new paper-money. The inevitable 1890 crisis changed the relation between the two levels of government with respect to taxation. The resources of the national government were affected by the balance of payment crisis, the lack of foreign credit. Besides that, the national government bailed out the provinces by assuming many of their debts. Under these circumstances, the local governments lost control over some internal taxes in favor of the center, as the Supreme Court made a broad interpretation of the Constitution. “Both levels of government collecting taxes over the same taxpayers proved to be an inefficient game”<sup>33</sup>.

For most of the twentieth century, the country had a *de jure* but not a *de facto* federalism, with an expansion in central authority and the demise of subnational autonomy. In the long run, intergovernmental competition and conflict prevailed, simultaneously with political and economic instability since the 1930s. In 1935, the

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<sup>33</sup> Tommasi, Saiegh and Sanguinetti “Fiscal Federalism in Argentina: Policies, Politics, and Institutional Reform”, in *Economía*, Journal of the LACEA, Spring 2001

first (of a series of) Co-participation (Revenue Sharing) Law changed the federal governance structures with the aim of improving efficiency. Nevertheless, recent federal fiscal outcomes in Argentina can be explained<sup>34</sup> in terms of a common pool effect. "Argentine intergovernmental relations have been the prevalence of **"executive federalism"**, the predominant role of governmental executives in intergovernmental relations"<sup>35</sup>. Moreover, due to **winner-take-all politics**, agreements between the national and provincial executives can be altered at the legislative or at the execution stage. On top of that, the "national executive is powerful as long as can buy support from quasi-feudal provincial governors with fiscal largesse"<sup>37</sup>. Spiller and Tommasi argue that in Argentina, the inadequate environment for efficient political transactions among jurisdictions is explained by a political game. Its features are the short-term horizon of Argentine legislators, the weakness of legislators, amid the power of governors, and a weak "horizontal" separation of powers. Powerful individual provincial governors influence in national policy-making and transfers, and exert disproportionate influence through congress (legislators have incentives to please them, who will place them on the party electoral list). There's also an overrepresentation of small provinces as well as the large vertical fiscal imbalances<sup>38</sup>. Therefore, it will be matter of future analysis the impact of redistribution of territorial frontiers in Argentina since late nineteenth century, which greatly altered the interprovincial balance of power in national congress.

The **federal constitution adopted in 1901 in Australia**, distributed legislative power

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<sup>34</sup> Sanguinetti 1994 in Tommasi, Saiegh and Sanguinetti "Fiscal Federalism in Argentina: Policies, Politics, and Institutional Reform", in *Economía*, Journal of the LACEA, Spring 2001

<sup>35</sup> Watts, 1999 in Tommasi, Saiegh and Sanguinetti op. cit.

<sup>36</sup> To analyze federalism functioning, Tommasi et al, consider the workings of federal systems as a game, in which the players are: subnational units and national political actors. In a non-cooperative game, the degree of possible cooperation will depend on several features of the game ("transactions environment": discount factors of the players, the number of actors, the observability of moves, "institutional" features specifying the timing of moves, the existence or not of some "exogenous" enforcement mechanisms, etc.) So if the transactions environment does not foster cooperation, then we will observe too much opportunism, leading to "volatile" collective decisions, and non-cooperative individual actions, economically inefficient choices and Underinvestment in capacities, leading to lower quality policies.

<sup>37</sup> Spiller, and Tommasi *The Institutional Foundations of Public Policy in Argentina: A Transactions Cost Approach*, Cambridge University Press 2007

<sup>38</sup> Spiller, and Tommasi 2007 op.cit



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over public policies between the Commonwealth and the State governments<sup>39</sup>, with the deliberate intent of defining the constraints on the central Government's legislative authority. The Federal Parliament, State legislatures and the High Court of Australia are important organizations. Only a limited number of substantive functions had been assigned to the Commonwealth in Section 51; the remaining was reserved for the States. Both institutions and organizations change over time in interactive ways. While institutions determine which organizations are created and for what purpose, organizations influence the evolution of institutions through their decisions and operations. Although during the past 100 years, the constitution has been amended only eight times, the current distribution of powers of legislative responsibilities is vastly different from the original design, especially through reinterpretations of particular sections. The States have contributed to the ascendancy of fiscal centralization since, after Federation, the mutual mistrust of the colonies continued among the States. The lack of horizontal co-operation among them gave additional reason for the Commonwealth to be involved.

The Constitution of Australia abounds in examples of incomplete or open-ended assignment of powers, allowing intergovernmental power struggle. The Commonwealth responded to the opportunities provided by the incompleteness of the constitutional contract soon. For example, although there is no constitutional prohibition on the States' authority to impose income tax, the States have been virtually excluded from this field since 1942. (See next section in this paper)

### **iii) Internal Structure of the Government: The Evolution of Income tax<sup>40</sup>**

Democracy should promote a shift from regressive indirect taxation to direct taxation. As an increasing proportion of society pays income tax, it becomes more difficult to coordinate collective action against it. Income taxation is highly dependent upon cooperation from taxpayers, reflecting their faith in the state. A decline in state credibility may provoke a switch to a negative path dependency and an opportunity for

<sup>39</sup> Grewal, and Sheehan. The Evolution of Constitutional Federalism in Australia: An Incomplete Contracts Approach, CSES Working Paper No. 22. Centre for Strategic Economic Studies. Victoria University of Technology. 2003

<sup>40</sup> Mitchell, Institutions and Factor Endowments: Income Taxation in Argentina and Australia, XIVth International Economic History Congress, Helsinki, Finland, 2006



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change in collective action. **Australia and Argentina's different institutional environments have consequences for social consensus and collective action.**

Until WWI, Argentina and Australia had a similar dependence upon indirect taxation. They were remarkably similar both in the amount of income that was subject to income tax relative to GDP prior to WWII, at around 10-13%, and in the amount of income taxation paid which was around 1% of GDP.

From the late nineteenth century, there was early support for income taxation in **Argentina**. The need for an overall reform of fiscal institutions was obvious by the early 1920s, and income taxation was successfully introduced in 1932, with the aim of increasing federal revenue. It wasn't attached to a greater reform of fiscal-federalism, but, nevertheless, it was able to overcome the constitutional obstacle of article 67, which stated that direct taxation was a provincial responsibility and could not be levied by the federal state unless it was temporary and due to an emergency<sup>41</sup>. The Peronist regime which began in 1946 greatly increased government expenditure and the budget deficit increased, concealed by indirect financing, i.e. seigniorage<sup>42</sup>. In addition, income taxation became an explicit tool for income redistribution. In 1950 it became more progressive, and new income taxes on extra profits and extraordinary profits were introduced. Argentine income tax evasion grew strongly helped by the lack of sufficient means to prevent evasion, the opportunities for tax amnesty and the inefficiency of state expenditure.

From 1945-55, the socially conflictive democratic populism of peronism damaged confidence. Meanwhile inflation, due to seigniorage, drove a rapid bracket creep, undermining the justice of income taxation and encouraging non-cooperation. When income taxes are growing faster than the real economy, it is likely that they will eventually be perceived as unjust, thus reducing tax morale. This may have encouraged

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<sup>41</sup> Congress avoided the need for considering constitutional reform by simply introducing income taxation as an emergency temporary device valid for five years.

<sup>42</sup> Almost 50% of expenditure was outside the formal budget, supported a policy of import substitution, being spent on IAPI (Argentine Institute of Trade Promotion), National Mortgage Bank and the state rail system.



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collective action to evade it, and induced **switching path dependencies**. Diminishing argentine state credibility generated a **‘lack of solidarity’ between state and society**.

Income taxation in Argentina and Australia were fragile prior to WWII, as were dependent upon the cooperation of few individuals. Later on, unlike Australia, Argentine income taxation retained its dependence upon the cooperation of a wealthy few; the only to ever pay a significant share of income taxation was the city of Buenos Aires. The boundaries to the collective action of the taxpayers were not high. World War II resulted in a great divergence between both countries regarding the income tax perception.

Income taxation in **Australia** had begun with the gold boom of the mid nineteenth when regressive indirect taxation financed growing needs, increasing demands for more progressive taxation<sup>43</sup>. Between 1877 and 1915, all the colonies (States after 1901) introduced taxes on land, with the original aim to ‘unlock the land’ for agriculture, but not to discourage wealth creation, levying taxation only upon the original unimproved values of the land<sup>44</sup>. With economic growth, wealth also took the form of other assets. In 1915, a federal progressive income tax was introduced, widely accepted to raise revenue because of the War but also to redistribute income. It didn’t tax ordinary wage and salary earners until the late 1920s. Wage taxation was introduced in the 1930s. All political parties supported the income tax, as long as it became a mass tax. And as it was more entrenched as a mass tax, it got more resilient.

By 1942 Australia had 26 separate income taxes, which burdened taxpayers unequally. World War II provided an opportunity for a fiscal-federal reform. The move to exclusive federal income taxation reinforced progressivity. The tax was lifted in 1943, but in 1945 the increment was renamed as a ‘Social Services Contribution’, and the state provision of many public goods increased the barriers to concerting collective action amongst taxpayers. Income tax became Australia’s star fiscal institution. Real

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<sup>43</sup> The first direct taxes, death duties, were introduced in 1851, but were relatively insignificant in terms of revenue

<sup>44</sup> In 1910 federal land tax successfully encouraged subdivision and more intensive production, was abolished in 1952 to compensate the states for their loss of income taxation in 1942.



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incomes grew substantially, improved the possibilities of the mass to pay, and reinforced path dependency. Between 1942 and 1955, income tax rates were increased 18 times. These measures were initially successful in increasing income tax revenue, but quickly failed thereafter as evasion became widespread.

#### IV. Conclusion

Democratic survival requires that governments rationally observe limits on their behavior. Winner-take-all politics and the tragic brilliance of the mechanism underlying the survival of one-party dominant regimes represent a pathology of both democracy and federalism. Political institutions should credibly commit the government to honor economic and political rights of the citizens. In addition, limited government depends on how citizens react to a potential violation of the rules. In this regard, the concept of **civic capital** is a central determinant of the informal institutional frame. Applying Weingast cited analysis of democratic stability to federal governance structures, we can argue that **not only formal institutions, but citizen values and behavior, as well as elite attitudes, will support federal governance structure.** Nevertheless, behaviors evolve and can quickly change by the surge of abrupt social, political or economic shocks. Some of these shocks can be domestic, and take the form of modifications of internal frontiers or jurisdictions that redistribute population. Shocks can also be external like big waves of mass migration. **One conclusion is that the only possible secure informal institution to sustain stability is a set of low level norms: permanent shared values, justified in moral terms.**

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