The Future of Federalism: Intergovernmental financial relations in an age of austerity: implications for the future of federalism

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ABSTRACT
This paper is an adapted version of the Conclusion of the forthcoming book The Future of Federalism: Intergovernmental Relations in an age of Austerity (Edward Elgar, January 2017) which summarises the key findings of the 12 country study of emerging trends and dynamics in intergovernmental financial relations.


Introduction: The Evolution of Intergovernmental Financial Relations in the 21st Century
Richard Eccleston, Rob Hortle and Richard Krever

PART I
1. Fiscal Federalism in the 21st Century
Richard Eccleston, Richard Krever and Helen Smith

PART II
2. Beyond the Financial Crisis: The Future of Fiscal Federalism in the United States
Paul L. Posner and Timothy J. Conlan
3. The Financial Crisis and the Future of Federalism in Canada
Douglas M. Brown
Richard Eccleston and Richard Krever
5. The Gathering Storm: Federalization and Constitutional Change in the United Kingdom
Simon Lee

PART III
6. German Federalism at the Crossroads: Renegotiating the Allocation of Competencies in a New Financial Environment
Jan Schnellenbach
7. The Future of Swiss Federalism: The Challenge of Fiscal Stabilization Policy in the Absence of Coordination
Nils Soguel
8. The Financial and Political Crisis of Spanish Federalism: Transformation or Erosion?
César Colino and Eloísa Del Pino
9. Italian Federalism in the Balance – Suspended Between European Integration and Domestic Devolution
Emanuele Massetti

PART IV
10. The Financial Crisis and the Challenge of Fiscal Federalism in China: The 2008 Stimulus and the Limits of China’s Intergovernmental System
Christine Wong
11. Indian Federalism Beyond the Financial Crisis
Raghbendra Jha
12. The Global Crisis and Brazilian Federalism: Effects and Perspectives
José Roberto Afonso and Luiz De Mello
13. The Impact of the Financial Crisis on Intergovernmental Financial Relations in South Africa
Ramos Mabugu

PART V
Richard Eccleston, Richard Krever and Peter Mellor
INTRODUCTION
The financial crisis which first disrupted global markets in 2008 may have been the defining global socio-economic event of the last decade, but the analysis summarised in this paper suggests that the crisis and its aftermath is but one, albeit a significant, factor shaping the evolution of federal systems. In this sense, this paper affirms existing research on comparative federalism that highlights the complex and particularistic nature of many federal settlements and their evolution over time (see, e.g., Benz and Broschek 2013; Fenna 2014; Riker 1964; Stepan 1999). Indeed, the cases within the broader study which this paper summarises will disappoint those anticipating that the impact of the financial crisis on federal systems over time can be explained in terms of a handful of key variables. However, it accords with the growing recognition in federalism scholarship and institutional analysis more generally of the complex nature of social change and the way in which it is influenced by the socio-economic interdependence between states as well as the cultural, political and economic forces within national borders. This growing recognition of the complexity of federal dynamics has resulted in a research environment in which formal, deductive methods are losing favour (Hueglin 2011).

Yet the complexity of federal systems does not mean that these changes are impervious to systematic analysis. Indeed we argue that this complexity necessitates a historically grounded, inductive approach that relies on detailed empirical research but utilizes existing theoretical propositions, models and frameworks to interpret the inherent complexity of the political world. Reflecting this methodological approach, our analysis is informed by what Kay (2006, p. 1) describes as a structured narrative that ‘seeks out the specific institutions, structures, and processes that are embodied in a given historical setting … and will construct explanations of outcomes that link the causal properties of those structures to the processes of development that are found in the historical record’. Consequently, the case studies considered in the broader project have examined the unique socio-political and economic circumstances of the federations analysed, while linking their experience with the broader theoretical themes in federalism literature.

This paper summarises more detailed case studies of the changing nature of intergovernmental financial relations across a broad sample of federal systems, providing an overview of common trends and patterns across cases. This analysis reveals that, despite the unique experiences of each federation, trends and patterns can be identified in federal responses to crisis management and budget controls. Perhaps more significantly for an analysis of future prospects of federalism, the long term effects of the crisis have involved both centralizing and devolutionary trends, and growing political tensions within heterogeneous federal states in particular. These trends have ramifications for both our theoretical understanding of the dynamics of federalism and the practice of federal governance.
THE FUTURE OF FEDERALISM: KEY TRENDS IN CONTEMPORARY FEDERAL GOVERNANCE

A central assumption of the study was the need to adopt an expansive definition of ‘federalism’, so as to include ‘federalizing’ systems as well as constitutionally established federal states. This broader definition allowed the inclusion of unitary or quasi-federal states that are subject to a ‘federalizing’ dynamic, as well as large emerging economies, such as China, that feature a devolved system of public finance. Following from these assumptions, our 12 cases were grouped into three broad categories:

(a) ‘Anglo’ federations including the US, Canada, Australia and, reflecting the contemporary push to devolution, the UK. These studies constitute Part 2 of the volume.

(b) Continental European federations including Germany, Switzerland, Spain and Italy. These studies form Part 3 of the volume.

(c) Emerging economies with formal federal structures or less formal federalizing characteristics including China, India, Brazil and South Africa. These studies constitute Part 4 of the volume.

Our analysis indicates that these countries exhibit considerable diversity across a host of geographic, social, cultural and economic variables, in addition to possessing distinctive federal structures. These federal structures include, for example, unitary systems with some measure of legislated devolution (UK, South Africa), ‘nested’ hierarchies (China) or, conversely, entirely independent (Brazil) multi-tier systems, asymmetrically devolved structures (Italy, pre-1996 apartheid South Africa), and strongly regionally-autonomous (Switzerland) or highly integrated systems (Germany), along with the perhaps classically ‘dualist’ federal system of the US. Other cases such as Australia, Canada and Spain exhibit combinations of these characteristics.

Reflecting the diversity of federal structures further distinctions could no doubt also be drawn between systems with ‘written’ or ‘unwritten’ constitutional arrangements, and the extent to which a role for dispute resolution is conferred upon judicial bodies (Weill 2014). Similarly, along with their differing federal structures, these countries also possess a range of different taxation and intergovernmental financial systems, and may also operate within larger areas of political or economic union, such as the European Union or the North American Free Trade Area.

A point crucial to the systematic analysis of the impact of the financial crisis on each of these federal systems is that the governmental responses to it can only properly be understood in the context of the unique history and development of each case and its institutional foundations. In that sense, each federal system is unique, and each country’s distinct historical trajectory and political legacies provide the economic context in which the crisis unfolded, influencing the affected actors and political concerns. Institutional responses to these challenges have thus been constrained, to varying degrees, by historical path dependency.
To note only a few of the economic factors relevant to the impact of the crisis, countries with a strong natural resource base (Australia, Brazil, Canada, South Africa) or manufacturing export sector (Germany, China) fared better than diversified industrial economies (Italy, Spain and the US), or those placing reliance on a specialized financial sector (UK and also, to some extent, the US, although Switzerland fared well due to its safe haven status). Similarly, demographic factors also play an important part, either through the possible fiscal challenges of an ageing society (e.g., Australia, Brazil) or the infrastructure demands and political challenges of a large youth profile (South Africa, India).

However, to note the diversity of federal systems and the associated variety of intergovernmental practices is not to deny the fact that general trends can be observed across the case studies. For example, the widespread uptake of broad-based value added taxation systems and ongoing reforms to those taxes continues (James 2015) and was observed in the cases of India, Brazil and Australia in particular. More generally, the issue of income and wealth inequality (both interpersonal and interregional) has come to be recognized as an increasingly serious problem worldwide and the growing political contestation over which regions and segments of society should shoulder the burden of fiscal repair has become a major theme in federal politics (Brooks 2010, pp. 200-204). Nevertheless, these broader trends and forces are mediated by local institutions and conditions, which helps to explain the diversity of responses to the financial crisis in federal systems. A more detailed analysis of broader trends observable in the aftermath of the crisis is presented below.

Crisis management
A consistent theme across all jurisdictions was the severe initial economic impact of the crisis itself and the need for a range of immediate policy responses. Longer-term ‘second stage’ effects only emerged after the initial crisis and response, after, in some cases, an intervening period of many years.

Within the context of the varying economic characteristics of the countries studied, there was little or no correlation between adoption of pro- or counter-cyclical macroeconomic policy in response to the crisis and subsequent economic performance or outcomes. Some federations adopted counter-cyclical policy and performed relatively well, whilst others suffered sharp declines; the same is true of those countries that adopted pro-cyclical policies, usually to meet codified budget rules imposed nationally and/or by the European Union. Australia, for example, adopted a counter-cyclical policy characterized by extensive fiscal stimulus measures including infrastructure investment and direct cash injections to households and performed well (aided significantly by the crisis coinciding with a commodity boom which Australia was well placed to capitalize upon), escaping the crisis relatively unscathed. Canada adopted a counter-cyclical macroeconomic policy and experienced, at least in the short term, a sharp economic decline - perhaps due to its significant economic dependence on the US. Germany adopted a fiscally conservative policy and refrained from large scale stimulus programs (a key reason being the constitutional debt brake on public borrowing), and yet recovered fairly well from the crisis thanks to increasing tax revenue and historically low interest rates on government bonds. In contrast, the UK pursued a pro-cyclical austerity policy and yet has been particularly hard-hit by the crisis with public debt remaining high due to lower tax revenue and increased social expenditure. Finally, the
Italian government pursued austerity (penalizing regional and local governments in the process) but the debt to GDP ratio has dramatically increased as a consequence of negative growth. Regardless of whether a pro- or counter-cyclical policy was adopted, and regardless of whether initial performance by a federation was strong or weak, it was consistently the case that each country experienced a ‘two-stage’ crisis – the initial 2008-09 shock, followed by a prolonged period of budgetary decline and an emerging need for fiscal consolidation.

Other cases are worthy of more detailed reflection. As the ‘epicentre’ of the crisis, including the collapse of the sub-prime mortgage market and subsequent banking failures from 2007, the US experienced a much deeper and subsequently longer-lasting downturn than it had in previous recessions. The policy response included large and ongoing stimulus measures, such as the Troubled Asset Recovery Program and American Recovery and Reinvestment Act of 2009. The banking and insurance bailouts involved a large-scale transfer of capital from government to the corporate sector. Similarly, many European jurisdictions, such as the UK, Spain and Italy, felt an initial impact followed by a second wave downturn and have been confronting the significant political and economic implications ever since.

In contrast to this experience was China’s quite remarkable and successful policy response (at least in the short term) in the immediate aftermath of the crisis, as a result of the unprecedented stimulus measures. Export centred economies such as Germany, and, in turn, economies dependent on them (such as Switzerland) were thus also able to avert the more significant consequences of the crisis. China’s expansion was also a major factor in the commodities and natural resources boom from 2009 which subsequently provided economic benefits to resource-based jurisdictions (Australia, Brazil, Canada, South Africa) through until 2014.

A consistent element of these more successful experiences was the strong role taken by the national governments in economic management, combined with unprecedented cooperation from subnational governments. Pre-existing intergovernmental institutions responded effectively – in Australia, the Council of Australian Governments facilitated a coordinated rollout of infrastructure projects, and swift action was facilitated in Canada by the Council of Finance Ministers and the Council of Federation. Indeed, even pre-existing ongoing reform processes in Germany and Italy generally did not impede effective short-term policy action. This evidence is consistent with other accounts of the response of federal systems to the acute phase of the crisis, which dispel concerns in the pre-crisis literature that federal structures tend to impede the macroeconomic response to financial crises (Erk and Swenden 2010, p. 8). Overall, it appears that in the period between 2008 and 2010 the prospect of a global depression inspired unprecedented intergovernmental cooperation and solidarity in federal systems.

**Budget controls and cost shifting**

One of the most important direct impacts of the financial crisis over the medium term has been the subsequent pressure imposed on public finances. This pressure has resulted from the combination of extraordinary spending and bailouts alongside declining revenue growth, leading to strenuous and often painful efforts to keep burgeoning deficits within manageable limits. In most cases, countries entered the initial phase of the financial crisis with quite strong public
finances after a long period of economic growth and fiscal consolidation, only to have this progress undone in the aftermath of the crisis.

The crisis had a detrimental impact on national and sub-national public finances in all cases studied, but the most vulnerable jurisdictions were those which failed to maintain market confidence in their sovereign bonds. ‘Safe haven’ jurisdictions with strong perceived creditworthiness saw bond rates driven down, benefiting the governments’ ability to finance spending and capital works (Germany, Switzerland). In contrast, countries in a precarious fiscal position saw bond prices fall quickly and heavily (Italy, Spain), imposing a need for further austerity.

Mounting budget pressures in the aftermath of the crisis have had a number of related consequences for federal systems, the political implications of which are just being realised. Perhaps one of the more significant trends which has been emerging in some federal jurisdictions involves the national governments’ pursuit of deficit reduction through cuts to vertical transfers to lower-tier governments and cost-shifting in general. This pattern has been particularly notable in Italy and Brazil, and has been foreshadowed in Australia; it is also typified by the ‘fend for yourself federalism’ approach adopted in the US, whereby the federal tier of government gradually shifts fiscal responsibility to the sub-national tier (Shannon 1987). In many ways, this is a pernicious trend from a traditional federalist perspective – particularly for those states whose federal settlement was predicated on greater fiscal control at the centre. Crucially, it poses the risk of undermining the federal economic settlements and mechanisms for intergovernmental cooperation that have underpinned the relative stability of wealthier federations in particular. That these trends have been less pronounced in multi-national federal states with acute regional secessionist movements, such as Spain and the UK, is perhaps implicitly indicative of the potential for intergovernmental tensions that flow from such a cost-shifting strategy.

Another influence on the fiscal response to the crisis across the cases studied was the extent of ‘debt brakes’, ‘ceilings’ or other measures designed to limit the expansion of government debt. The US is a key example of a jurisdiction with widespread adoption of debt limits in some form at the state level and a requirement for regular extension of a federal debt ceiling, which has often created deadlock between the branches of government. From a comparative perspective, these measures were adopted by other jurisdictions in the lead-up to the crisis (on Europe, see van Malleghem 2014).

Other nations adopted these measures after the crisis, as part of the long-term policy response. Constitutional limits were imposed in Germany in 2009 and are gradually being implemented in Switzerland at the cantonal level to augment the federal rule. In Germany the constitutional debt brake has created political problems for some state governments (those with historically accumulated public debt) due to unpopular spending cuts – they have few means to increase revenue to meet the constitutional requirements. Significantly, levels of indebtedness vary across the German federation. There is also significant tension due to the four stage fiscal equalization regime that attempts to deliver equal public goods to each state – the fiscally weaker states prefer to expand vertical fiscal relations, whilst the stronger states prefer more tax autonomy.
The continuation of strong fiscal equalization measures at present in Germany (until 2019) means that it is still too early to assess the effectiveness or costs of the new limitations in that country, precluding confident extrapolation to other jurisdictions.

Other jurisdictions have not employed formal borrowing constraints on the various levels of government (Brazil, Canada and Australia). Interestingly, the Canadian provinces lack ‘hard’ or ‘soft’ budget constraints and have diverse national resource endowments – and yet a significant degree of budgetary policy convergence has been observed in that country. The states in Brazil have only recently resumed borrowing programs again, while the UK has only just restored some borrowing capacities to the devolved entities in the context of otherwise strong and long-term central Treasury control of spending and finance from London. These findings suggest that budgetary controls did not have a decisive impact on economic performance, but may be a factor impacting on deficit reduction prospects in the short term.

Perhaps the most significant dynamic example of the crisis influencing borrowing practices among the lower tiers of government occurred in China. The ongoing shift to a market-based economy and privatization of state-owned entities provided an opportunity (ongoing since the 1980s and 1990s) for local governments to circumvent central financial oversight and management by establishing special purpose corporate vehicles to implement projects with debt-financing on a vast scale. The nature and effectiveness of the more recent central government efforts to reassert control and deal with this outstanding debt will be a key issue for China itself and the global economy in future years. The 2014 Budget Law in China gives the provinces the right to borrow directly, but this will allow a much greater opportunity for central government oversight and accountability.

Centralizing or devolutionary trends?
The economic and budgetary trends described above have had a number of structural and political ramifications. A clear conclusion is that the crisis has had a centralizing effect on many federal systems, at least in its initial economic impact. Consensus for major stimulus measures (the US, Australia, Canada), policy convergence (Canada, Switzerland), and either continuation of long-term centralizing reform (Germany) or interruption of de-centralizing reforms (Italy, South Africa) can all be viewed as strengthening the relative position of national governments vis-à-vis the sub-national administrations. Similarly, the regional autonomy increasingly granted by the Spanish government in the pre-crisis environment to reflect political imperatives and Catalonian demands for independence has been wound back post-crisis, as the debt crisis and subsequent austerity measures have contributed to greater pressure for the objectives of equalization and policy coordination mechanisms.

However, the picture is less clear insofar as longer-term trends are concerned. For example, important and historic ‘headline’ devolutionary reform processes have been put in motion in the UK (Memorandum of Understanding on Devolution of 2012) and India, along with a less outcome-focused ‘reform of federation’ review in Australia (which was downgraded to an Expert Advisory Panel in April 2016). Promisingly for the Indian reforms, some of the very strong recent economic growth has been concentrated in the least affluent states, lessening pressure on inter-regional equalization systems (see below).
Devolutionary pressures may also emerge in jurisdictions which only suffered mild recessionary conditions due to the global resources boom (Brazil until 2014, Canada and Australia) given that the legacy of the boom may include heightened inter-regional disparities and tensions. Switzerland may also encounter effects from the rapid unwinding of bank secrecy laws, where banks are concentrated in only some of the cantons. Moreover, Italy’s centralizing pattern since the onset of the financial crisis has been accompanied by increases in regional policy responsibilities even as there have been cuts to regional budgets. The new Indian government is also showing signs it is prepared to confer more fiscal autonomy upon states through increasing shares of central tax receipts and devolution of some powers. Brazil is also quite decentralised, with state and local governments accounting for a much higher share of revenue than is the norm and municipalities increasing their share of tax receipts. Perhaps again the most significant case in terms of its implications for the global economy is China, where the central government has to date been highly successful in national macroeconomic management although, as noted above, there are growing concerns about the sustainability of the Chinese model in light of growing debt at the sub-national level.

Yet it does not follow that these observed changes in centralisation patterns reflect any impetus for formal constitutional federal reform. As Fenna (2014) notes, federal change may be characterised as either formal reform or informal adaptation to short to medium term pressures. In the cases studied, a key issue in assessing any ‘devolution’ that has occurred is the extent to which these processes have involved an actual alteration in constitutional powers or sovereignty within the geographical area of the country, or merely a decentralization of administration and service delivery responsibilities, or of fiscal and taxation powers for the achievement of economic efficiency or subsidiarity benefits (Feeley 2012). The latter would not necessarily be viewed as involving a real or lasting change to the federal balance in the countries concerned, or give rise to doubts on the same scale about the viability or ‘future’ of federalism as an institution. One variable highlighted in the theoretical literature on institutional change which provides insights into the circumstances under which informal adaptation is consolidated into enduring constitutional change is the recent literature of ‘situated agents’ in institutional analysis (Bell 2011; Marsh 2009). Such accounts recognise how the pressures for change in federal systems and indeed the broad parameters of reform agendas themselves are shaped by economic circumstances and institutional context, yet the prospects of formal reform are very much dependent on effective leadership which mobilises support for the case for federal reform. Indeed, regional movements that have extracted economic and political concessions in the UK and Spain have been successful in large part because existing independence movements have had effective leadership. In contrast, the case for modest federal reform in countries such as Australia has waned in the absence of effective political leadership resulting in an environment where incremental adaptation appears to be the only viable path to intergovernmental reform.

Perhaps ironically, it is the developments outside domestic politics, involving the issue of potential further upward transfer of national sovereignty to emergent supra-national groupings, which may be more significant for the institution of federalism. The impact of the national referendum in the UK on whether to leave the European Union, for example, and ongoing efforts to develop international taxation institutions with binding arbitration powers, for example, may
lead to subsequent reverberations in terms of the nature of the remaining sovereignty within the countries concerned.

**Political tensions**

Predictably, the crisis and its implications for economic growth and public finances also gave rise to new political tensions or exacerbated pre-existing intergovernmental conflicts. The most direct linkage between the crisis and political turmoil can perhaps be found in the US, the epicentre of the crisis. Since the acute phase of the crisis (largely coinciding with Democratic Party control of both Houses of Congress between 2006 and 2010), US politics has continued to become more polarized and devise. While most analysis focuses on the implications of polarisation on national policy making this dynamic has also had significant implications for US federalism. Specifically state governments have become increasingly reluctant to negotiate with a federal administration of the opposite party compromising cooperation between the branches of government at all levels. This was exemplified by Congress causing a government shutdown in 2013 over the federal budget and efforts to increase the debt ceiling, and the repeated shutdown threats since. More generally, the intergovernmental effects have been characterized as causing the development of ‘fend for yourself federalism’.

The Australian experience has been similar in many ways, once allowances are made for the difference from the US in terms of successful avoidance of an initial recession and the much slower unwinding of the resources boom. Somewhat ironically, the resources boom itself became a catalyst for political tensions following the unsuccessful efforts of the Labor government to impose a new national tax mining profits (Eccleston and Hortle 2016). Subsequently, Australia has seen a number of leadership changes at the federal level and its first period of minority federal government (2010-2013) since World War 2. The acute phase of the crisis from 2008-10 itself saw perhaps the apogee of a process of ‘cooperative federalism’, coinciding with a period where the federal government and all state governments were governed by administrations from the one party (Labor). However, subsequent tensions resulting reform plans to transfer state responsibilities (such as health and hospitals) to the federal level, and conversely to achieve federal budget savings through cost shifting to the states, have seen the system revert to ‘competitive federalism’ or even ‘opportunistic federalism’.

Canada, by contrast, has seen much less political tension than its ‘Anglo’ counterparts of the US and Australia, and certainly no return to the political conflicts witnessed in the 1970s and 1980s. Institutional vehicles for intergovernmental cooperation, such as the Council for the Federation, continue to build a successful track record (Chordia and Lynch 2015, pp. 351-354), and intergovernmental disputes involving joint administration of policy programs have been minor.

The political effects of the crisis in other jurisdictions have been either muted (Italy), or incorporated into longer-term federal reform processes with some alteration in the trajectory of those reforms (Germany). In other cases, potential sources of dispute relate more to management of regionally concentrated growth (India), the transition of longstanding economic growth to a more mature domestic consumption-focused economy (China), or infrastructure development issues (South Africa).
A final point is that political developments in the UK have the potential to give rise to wider ramifications in European as austerity and the pursuit of a ‘holding together’ policy approach raises significant political questions, not least that of Britain’s continued membership of the EU and how this might affect its position in other bilateral and multilateral relationships.

Inequality and pressures on the architecture of fiscal equalization

Beyond these general political tensions, more acute problems can be identified with respect to fiscal equalization programs. One of the distinctive features of many federal systems is the operation of a regime to promote fiscal equalization between different regions. The forms of these regimes vary from the very minimal allocation of grants for particular programs (the US, Switzerland), or somewhat loosely administered but more formal redistribution mechanisms (Canada, India, the UK) or, at the other end of the extreme, highly specialized and formula-based schemes aiming to achieve a legislatively or constitutionally mandated outcome of ‘comparable’ economic standards for all citizens (Australia, Germany). The specifics of the equalization process in each country are closely tied to historical and cultural experience.

Fiscal equalization is inevitably one of the most significant specific focal points for horizontal political tensions within a federation. It has long been recognized that the calculations involved are necessarily imprecise, even if presented in a highly scientific way (Head 1983). Indeed, Braun and Trein (2014) argue that equalization regimes are likely to become a major point of political contention in the context of post-crisis fiscal consolidation in federal systems. Specifically, strongly redistributive equalization schemes between regions invariably carry significant economic efficiency costs (e.g., influencing subnational decisions on tax policy) and will not necessarily affect horizontal equity between individuals in the country (e.g., if transfers are made from populous ‘wealthy’ regions, but funded from regressive taxes on lower income workers, to ‘poor’ regions which disburse the funds to their wealthier residents).

The case studies in this project confirm that fiscal equalization processes have generally come under pressure as a result of the financial crisis. In the US, political polarization has seen some states reject federal assistance and participation in federal programs on political grounds, while in the UK, the ‘Barnett formula’ has been scrutinized much more closely in England in the face of demands from some quarters for greater devolution of powers or increased representation in the UK Parliament. Efficiency costs are being recognized to a much greater extent in Australia and Germany, while economic volatility has put the formal calculation processes (often based on a rolling average of data over several prior years) under strain.

It is only those jurisdictions with strong continuing economic growth where pressures for reform of equalization processes are likely to abate (China, India) or merge into larger demands for infrastructure and government services (South Africa). These tensions over formal equalization regimes reflect the long term and cross-jurisdictional pattern of inter-regional tensions between wealthy, resource-rich states and provinces and less prosperous regions. To this end, the tension between the resource-rich and mining Canadian provinces and Australian states and their sometimes poorer and sometimes richer counterparts (depending on global demand for
commodities), for example, are not new (Eccleston and Woolley 2015). Moreover, the debates over equalization in Germany and Spain long pre-date the crisis. Nevertheless, the exacerbation of these tensions arising from the budgetary constraints felt by all levels of government in the aftermath of the crisis warrants careful attention.

**FEDERAL DYNAMICS: THEORIZING CHANGE IN INTERGOVERNMENTAL SYSTEMS**

While the financial crisis of 2008 arguably represents the greatest economic shock to the global economy in recent decades, intergovernmental relations in the years following the crisis have been characterised more by continuity than change. All the cases we have examined have been subjected to common economic pressures as a result of increasing financial integration and interdependence, and many jurisdictions have adopted common or coordinated responses, yet federal dynamics and practices are mediated by domestic social, political, legal and economic factors and the strategies of political leaders and key actors in the policy process.

In terms of the theories of institutional change, this finding suggests that federal orders are deeply institutionalized and path dependent (Ackerman 1991, 1998; Collier and Collier, 1991; Mahoney 2000; Pierson 2004; Bennett and Elman 2006; Capoccia and Kelemen 2007) and resistant to change. Yet such a conclusion belies the informal processes that are altering the intergovernmental practices and, over time, the formal structure of federal orders. Perhaps the most influential account of these incremental yet cumulatively significant endogenous processes is Mahoney and Thelen’s (2010) theory of gradual institutional change with its emphasis on four discrete pathways that can result in significant reform over time.

Broschek’s (2011) authoritative review of the application of Historical Institutionalism to the theorization of institutional change in federal systems rightly identifies incremental theories of institution change such as that advocated by Mahoney and Thelen as providing a promising framework for theorizing federal dynamics. Specifically, (Broschek 2011, p.553) applied the four pathways to change identified by Mahoney and Thelen (Layering, Drift, Displacement and Conversion) to the case of federal systems (See below). Yet the question remains which of these four processes identified in the extant literature is evident in the cases presented in this study?
Pathways to federal reform

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<th>High degree of rigidity</th>
<th>Explicit Change</th>
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<td>Layering: introducing new rules alongside or above existing rules</td>
<td>Drift: changed impact of existing rules due to environment shifts</td>
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| Low degree of rigidity | Displacement: removing existing rules and introducing new rules | Conversion: changed enactment of existing rules due to strategic development |

Source: adapted from Broschek (2011, p. 553).

Analytically, Broschek’s framework anticipates that the nature of change evident in a political system will be shaped by the degree of institutional rigidity within a federal order and the extent to which pressures for change are explicit or implicit. In practice establishing the level of institutional rigidity in a federal system is problematic given that change can occur at a range of different levels. For example, federal orders have many dimensions some of which are deeply entrenched constitutionally including the constitutional allocation of competences; the structure of representation of constituent units in federal legislatures and the role of constitutional courts. In contrast, the allocation of financial resources is less rigid and, as we have seen over the past decade, subject to vagaries of economic conditions and funding decisions. Federal orders have constitutional elements which are extremely rigid alongside fiscal elements that are much more malleable and dynamic.

What are the implications of the hybrid nature of federal systems for Mahoney and Thelen’s typology of institutional change? First, we can conclude that many of the federal regimes analysed in this study have been subject to a process of ‘institutional drift’ where changing environmental conditions (revenue and funding decisions) result in the existing rules having a changed impact. Perhaps the most obvious example of this from the study was the use of existing intergovernmental funding programs to administer and deliver economic stimulus during the acute phase of the crisis. This crisis management strategy was exemplified by the Canadian federal governments’ ‘Economic Action Plan’, which leveraged existing intergovernmental grant arrangements to stave off the worst effects of the crisis through, among other things, infrastructure spending. Similarly, the Australian federal government directly involved the Australian states through its ‘Building the Education Revolution’ stimulus measures. An indirect illustration of revenue and funding decisions impacting pre-existing rules can be found in Brazil, where the federal government encouraged greater stimulus spending by subnational governments through extending guarantees and providing financial credit. Though no formal constitutional change in fiscal responsibilities occurred in any of these examples, the pre-existing economic distribution of responsibilities permitted considerable flexibility and adaptation in response to the crisis.
In addition to the institutional drift, according to many of the contributions to this collection, this process will not only change the short-term practice of intergovernmental relations but may also result in a process of ‘institutional displacement’ whereby formal constitutional change eventually takes place as the system adjusts to new political and economic pressures. The most obvious examples are constitutional (or quasi-constitutional) concessions in the UK, although proposed fiscal and tax reforms in India, Brazil and Australian also reflect this process. For example, although the UK lacks a formal written constitution, the proposed devolution of significant tax receipts to the Scottish government presents a radical change to the heretofore rigorously centralised British fiscal system. Another clear example of institutional displacement is the move in India to amend the constitution to allow application of a national goods and services tax. That such a long-necessary reform is now considered viable in the present environment of fiscal stress testifies to the ongoing impact of the crisis. This analysis is consistent with the emerging literature on adaptive federalism, where Fenna (2012a) argues that informal adaptation precedes more formal constitutional reform which occurs when the existing constitutional order is no longer ‘fit for purpose’ and in terms of Mahoney and Thelen’s (2010) typology is displaced.

More specifically in Australia’s case, leading constitutional lawyers have argued that the longstanding practice of reliance upon informal and extra-constitutional intergovernmental arrangements and agreements gives rise to a number of drawbacks and that ‘the time has come to accept that intergovernmental arrangements and practices in Australia now represent a distinct mode of governance for which more structured provision should be made, not only for the purposes of Australian federalism but also in the interests of Australian constitutionalism more broadly’ (Saunders 2012, pp. 429-430).

The broad dynamics in federal systems are far from automatic and the precise form of new federal settlements and reforms are influenced by a combination of the institutional dynamics described above and the actions of key political leaders and entrepreneurs, actors that Bell (2011) describes as ‘situated agents’. This is especially true of the transition from informal adaptation to more deeply institutionalised legislative or constitutional change. The evidence presented in this study broadly affirms Bell’s (2011, p. 891) claim that such processes are shaped by institutional structures which provide incentives and cues that can both constrain or enable change. However, their ultimate impact is controlled by the actors, be they individual political leaders or policy entrepreneurs, who have discretion over the agendas and strategies which they pursue. Significantly this approach recognizes the impact of prevailing norms and ideas, whether they concern regional identity or economic strategy, on patterns of federal dynamics both in terms of influencing how actors interpret their political context and how they frame and legitimize calls for political action and institutional change (Hay 2004). For example, regional movements in the UK, Spain and Italy did not form in a political vacuum. Rather, they are a product of strategic political actors and movements exploiting changing structural economic conditions to promote and effect change to entrenched federal orders. More detailed research is required to understand the role of actors translating implicit change (adaptation) into more explicit constitutional reform but the evidence presented in this study suggest that an ‘actor-centred’ institutionalism approach will provide rich insights into the path ways to federal reform.
THE FUTURE OF FEDERALISM

What do the empirical developments and their theoretical implications mean for the future of federalism? While the answer to this question inevitably involves a degree of speculation, the research presented in this study provides a solid foundation for starting the process.

The financial crisis and its aftermath represent a fundamental challenge for democratic governance. Yet while its influence on federal practices has been significant, it is but one dimension of a broader dynamic. Polarization, de-alignment and regionalism all make the challenge of sustaining a federal union more challenging. This is evident at a national level in federal jurisdictions from the United States to Spain and also at the supra-national level in the European Union (although not a major focus of the study). Political parties serve a key role in aggregating interests and, when they represent national movements, can exert a powerful centralizing force in federations. Moreover, the traditional rationales for centralisation – including fiscal equality and harmonisation – remain powerful.

However, mounting fiscal pressures and regional variations in economic performance noted above have intensified established trends towards political dealignment and fragmentation, contributing to increased tensions in federal systems. In the US this manifests itself as increased polarization and hostility between tiers of government, which hinders intergovernmental cooperation. Variations in economic performance has driven horizontal tensions in other regions – the fiscal pact in Australia and Germany, for example, is under threat from the growing disquiet of wealthier regions that object to shouldering more of the fiscal burden in the aftermath of the crisis. Yet other case studies have demonstrated the impact of cultural regionalism – in Europe, identity parties in Scotland (the Scottish National Party) and Spain (the Catalan Independence Coalition) have actively encouraged political independence movements, gaining traction from the
fraught fiscal environment. The precise implications of these developments are unclear but the changing nature of parties and party systems are threatening federal unions and represent an important factor shaping federal dynamics.

A second trend that will influence the future of federalism is the general tendency towards centralization, except where (as noted above) there are strong regional movements. In these cases, regional movements need to be accommodated if the union is to hold together (Stepan 1999). Another variation on this dynamic is the strategy being employed by some national governments to shift the burden of austerity to sub-national jurisdictions, either by cutting vertical transfers of reassigning spending responsibilities to lower levels of government as a means to repairing the national budget if not public finances as a whole. This tendency is evident in Australia, Canada, Brazil (through its ‘hour-glass federalism’ model) and, to a lesser extent, Italy. While such processes are often promoted as being part of a devolution process or federalizing reform agenda, such transfers of expenditure assignments without a corresponding increase in the fiscal capacity at the state or provincial level does little to promote the fiscal autonomy or political independence of regional governments.

Beyond debates about the appropriate level of centralization in a federal system, many argue that the degree of intergovernmental cooperation and integration is the most important factor influencing the efficacy of federal governance. To this extent, it is important to acknowledge the high levels of intergovernmental cooperation that were observed during the acute phase of the crisis across all cases - effectively countering claims in the established federalism literature that federal systems struggle to implement effective policy responses to crises (Olson 1965; Oates 1972). That this cooperation occurred across a diverse range of federations is a powerful argument in favour of the enduring relevance of the federal model of governance.

Nevertheless, it is not possible to make the claim that the crisis response heralded a new era of collaborative federalism, given that almost no new collaborative institutions were created. Although no doubt some blame lies with the rapid onset and acute magnitude of the crisis, the collective responses were ad hoc and improvised rather than institutional in character. And, notwithstanding the abovementioned cases where political instability and fiscal pressures have bolstered support for regional movements, generally speaking the findings presented in this study support Braun and Trein’s (2013; 2014) contention that crisis-induced instability contributes to centralization and increased horizontal tensions in federal systems. Our focus is on federal dynamics within states but, once again, similar dynamics have been observed within the EU in the context of the 2015 migration crisis. In this context, mounting political concerns about unprecedented levels of humanitarian migration are forcing member countries to abandon their long-held commitment to open internal borders under the Schengen Agreement in what amounts to a clear retreat from integration and federalization.

A final challenge for the future of federalism concerns the relevance of devolved governance and regimes of divided sovereignty in an era of welfare state retrenchment and an environment where new technologies and models of service delivery may counter the broader trend towards subsidiarity and federalization observed during the late twentieth and early twenty-first centuries. In their ground breaking 2005 study of federalism and the welfare state, Herbert Obinger and his
colleagues argued that by the late twentieth century national welfare systems promoted national solidarity, effectively acting as ‘the only glue that holds troubled unions together’ (2005, p. 355). This remains the case in the aftermath of the financial crisis and is exemplified by the fact that preserving national transfers and welfare payments was a decisive factor in the ‘no’ vote narrowly prevailing in the 2014 Scottish independence referendum. Obinger argues that the formal federal structure is the most practical compromise for governance given that unitary states ‘are no longer feasible’ (Leibfreid, Castles and Obinger 2005, p. 355). However, cases presented in this study highlight how devolved service delivery can occur in the absence of a formal federal system of divided sovereignty. In Brazil, for example, there is a clear pattern of ‘hour glass federalism’ in that the national government is by-passing the provinces and funding local government directly. A slightly different trend is emerging in Australia where individual needs-based funding regimes are being developed to enable individuals to purchase social services that suit their specific needs, a strategy that promotes devolved, place-based service delivery without the need for federal governance. The promise and potential of new modes of devolved governance which can balance the need for national coordination while respecting distinctive regional needs is significant, but whether such approaches will displace centuries old federal institutions and traditions is far from certain.

Federalism was and no doubt will continue to be a balancing act and a political compromise. On the one hand divided sovereignty by its nature creates accountability and governance challenges, problems that are exacerbated during times of economic crisis and fiscal consolidation. Yet on the other hand, strong systems of regional representation are perhaps the best antidote to the democratic decline and populism which afflicts most of the world’s democracies. The financial crisis and its aftermath has demonstrated that federalism can be both a cause and a cure of democratic disenchantment and political malaise. In this sense it is incumbent upon political leaders and the communities that they serve to work together to develop and, over time, formalize new modes of intergovernmental relations that can support efficient yet democratically accountable models of democratic governance capable of responding to the numerous challenges of the twenty-first century.
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