

Incentives to Experiment in Federal Systems

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Abstract

A well-known advantage of a federal system is that it allows policy experimentation by states. What is as yet unexplored is whether this freedom leads to the right experiments being undertaken. We develop a model in which districts at the sub-federal level have the ability to choose the ideological location of their experiment as well as how many resources to devote to it. We show that the free-riding problem in federal systems is particularly pernicious in this setting, and can induce Pareto dominated policy choices from all member districts. We also investigate the optimal design of a federal system and show that partial centralization is optimal, in which states begin with control of policy but ultimately relinquish it. This shows that the typically-analyzed settings of full centralization or full decentralization miss important parts of the analysis. The analysis offers a reinterpretation of federal systems as policy tournaments. We relate the prediction of our model to the evolving federal systems in the U.S. and Europe.