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Regions and Redistribution

Introduction and Overview

> Yes, when – not if – when we get a chance, the Federal Government will assume bold leadership in distress relief. For years Washington has alternated between putting its head in the sand and saying there is no large number of destitute people in our midst who need food and clothing, and then saying the States should take care of them, if there are. [. . .] I say that while the primary responsibility for relief rests with localities now, as ever, yet the Federal Government has always had a still and continuing responsibility for the broader public welfare. It will soon fulfill that responsibility.
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> Franklin D. Roosevelt, Nomination Acceptance Speech, 1932

> Now, if Spain were an American state rather than a European country, things would not be so bad [. . .] Spain would be receiving a lot of automatic support in the crisis: Florida's housing boom has gone bust, but Washington keeps sending the Social Security and Medicare checks. [. . .]
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> Now what? A breakup of the euro is very nearly unthinkable, as a sheer matter of practicality [. . .] So the only way out is forward: to make the euro work, Europe needs to move much further toward political union, so that European nations start to function more like American states.
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> Paul Krugman, *New York Times*, February 14, 2010

Economic downturns challenge governments and institutions. The Great Depression dramatically exposed the limitations of earlier approaches to social and welfare issues in the United States. Roosevelt's 1932 pledge to strengthen the role of federal government was a response to the failing paradigm, then dominant in federations, that state and local governments should fend for themselves. In striking parallelism, today's financial crisis presents a similar challenge to the European Union (EU). Krugman's plea for a stronger Europe highlights the tensions of a monetary union without a coherent fiscal policy. The presidential candidate in the 1930s, like the economist today, recognized the importance of fiscal structures in political unions.[1] This book defines fiscal structures as a combination of two factors: the level of centralization of income taxes and transfers; and the extent of redistribution between regional governments.

Fiscal structures are crucial to economic welfare during periods of hardship. Anyone driving around America today is likely to encounter constant reminders of a failed economy. Empty buildings, formerly busy car dealerships that once harbored a frenzy of transactions, now stand neglected. When the illusion of endless credit vanished in 2007 many Americans faced unemployment. Yet they did so on a very unequal basis. According to data from the U.S. Bureau of Labor, a sales agent in Arkansas, facing dismissal in the last quarter of 2007, would have expected a level of benefits equal to 30% of his wage for an average of fourteen weeks. A similar worker in California would have been entitled to about one-half of his previous salary for twenty weeks. In Pennsylvania, he would have received 60% of his previous earnings for eighteen weeks.

Across America, workers doing similar jobs are treated differently. These inequalities are partly due to the constraints Roosevelt faced in fulfilling his nomination pledge. However, political unions elsewhere did not encounter the same obstacles. Whereas Roosevelt could only pass legislation to incentivize states to launch their own unemployment insurance systems, the government of Canada adopted a national system in 1941. Similarly, workers in Germany can expect the same amount of unemployment insurance benefits regardless of where they live. I consider these differences in the territorial organization of taxes and public insurance systems to be differences in the organization of interpersonal redistribution.[2]

Both national and subnational (state, local, or regional) governments face increasing economic pressures during periods of rising unemployment. Naturally it is in their interests to help ailing sectors in times of crisis where possible. In the car industry, for example, major companies routinely lobby national and regional governments in France, Germany, and Spain for help to keep struggling plants operational. Likewise, states in the United States can subsidize production via tax incentives, as many Southern states have done. This has facilitated the entry of European and Japanese car makers into the American market, and altered the geography of car production in the United States. Alternatively, subnational governments may choose to facilitate a shift in their economic structures and bid for new investments at the expense of declining sectors.

[1] I define political unions broadly as entities where citizens are ruled by national and regional governments within a common economic space. The concept includes confederations, such as the European Union, all of the world's democratic federations, as well as countries undergoing processes of political and fiscal decentralization, such as Spain.

[2] The underlying assumption here is that most redistribution occurs through programs that are meant to provide insurance over the life course (such as unemployment benefits and pensions) and that the tools used to finance them (direct and indirect income taxes, insurance contributions) are, in part and to varying degrees, progressive. To the extent that for large sectors of society the benefits received exceed the amount justified by earlier contributions, insurance programs are also redistributive programs (Atkinson 1995; Moene and Wallerstein 2001; Varian 1980).

Whichever approach they adopt, subnational governments need resources. To the extent that they differ in the size of their tax bases, subnational governments are not equally equipped to face the challenge of sustaining employment levels. Wealthier states will be more able to cope with economic uncertainties and to secure new employment opportunities for their residents. Because subnational governments need resources to develop their own policies, the interregional transfers of resources between rich and poor areas is a central aspect of the politics of redistribution in political unions. Some federations, such as Germany, have instruments aimed at reducing the resource gap between subnational governments, thereby enabling them to provide equally for their residents.[3] Other federations, such as the United States, lack such instruments and either preserve or exacerbate the disparities in fiscal capacity among the union members. I consider differences in the reallocation of fiscal resources between subnational governments differences in levels of interregional redistribution.

The organization of fiscal structures determines how much redistribution, both interpersonal and interregional, there is in political unions, ultimately shaping the scope and profile of inequality. The distinctive feature of political unions, as opposed to centralized democracies, lies in the trade-off between the pursuit of equality and the protection of political autonomy. The fundamental dilemma at the heart of modern, democratic, political unions is how to reconcile the two goals of equality and autonomy. In an era in which social insurance and redistribution occupy the lion's share of governments' budgets, the tension between equality and autonomy manifests itself in a conflict over the design of fiscal structures. About one-third of the world's population lives in democratic political unions today. Hence, a real understanding of inequality requires a better grasp of the politics behind public insurance systems (interpersonal redistribution) and interregional transfers in political unions.

These are timely and understudied issues. Renegotiation of the fiscal contract is a prominent item on the political agenda in Spain, Italy, Belgium, and even the United Kingdom (with the ongoing discussions about Scotland and Wales). Beyond Europe, democracies as diverse as Bolivia, Russia, and India face similar conflicts. The way unions solve them illustrates an important, and largely overlooked, aspect of the political economy of inequality and redistribution.

To fill this gap this book develops a new political geography of inequality. I ask why some political unions show less redistribution and more inequality than others. In seeking an answer to this question, I develop a new comparative analysis of the politics of fiscal structures in political unions. I argue that the observable variation in fiscal structures and outcomes across political unions results from the combined effect of economic geography and political representation. By economic geography I refer to cross-regional differences in terms of income inequality and economic specialization. By political representation

[3] Here I make no judgment about the efficiency effects associated with the way these resources are actually spent.

I refer to the set of institutions, most notably party systems, electoral rules, and legislatures, which translate political preferences into policy choices. The former explains the set of contending preferences regarding the organization of interpersonal redistribution and levels of interregional redistribution. The latter explains the transitions to actual institutional choices and outcomes. This book shows how the combination of economic geography and representation illuminates the long-term foundations of inequality in political unions, thereby accounting for the observable differences between them.

My analysis provides an alternative framework beyond the simplistic reasoning that has dominated the field so far. In the rest of this chapter, I present the puzzles motivating this study, outline its main arguments, discuss how the book contributes to existing literature, and finally, address the challenges involved in pursuing these arguments empirically and how the book's structure responds to them.

PUZZLES: THE DOMINANT VIEW AND ITS LIMITS

The notion that federalism, and more generally fragmented political structures, necessarily means less redistribution and more inequality runs deep in comparative politics and political economy. A quarter of a century ago, Wildavsky proclaimed that "there is no escape from a compelling truth: federalism and equality of result cannot coexist" (Wildavsky 1984: 68). In a similar spirit, the notion that "in the American context, Madison, not Marx, seems to be having the last word" (Lowi 1984: 379) remains a widely held belief.[4] After all, the United States remains the most unequal among advanced democratic societies, and many countries with even more uneven distributions of wealth, such as Brazil or Mexico, have federal forms of government.

An overview of the intellectual history of the organization of power within political unions reveals that Lowi and Wildavsky are in excellent company. Welfare economists see federalism and decentralization as particularly adequate to balance the need to attend to both heterogeneous local preferences and cross-jurisdictional externalities.[5] Local provision of public goods copes better with informational asymmetries, preference revelation, and issues of adequacy between policy instruments and people's needs, whereas a central ruler

[4] See, among others, Huber, Ragin and Stephens (1993); Peterson (1995); Peterson and Rom (1990); Prud'homme (1995) as well as recent insights from institutional economic history by Alston and Ferrie (1999). On the role of federalism in the development of the American welfare state, see also Alesina and Glaeser (2004). For arguments elaborating on the efficiency gains associated with federalism, see Buchanan (1950, 1995); Inman and Rubinfield (1997a, 1997b); Oates (1999); Prud'homme (1995); Qian and Weingast (1997); and Weingast (1995). For positive analyses of the impact of federalism on the economy, see Brennan and Buchanan (1980) Cai and Treisman (2005); Rodden (2006); Treisman (2004, 2007); and Wibbels (2005a).

[5] See Gramlich (1973, 1987); Musgrave (1997); Oates (1972); Oates and Brown (1987, 1991, 1999); Wildasin (1991).

is supposed to achieve more efficient outcomes in those policy realms affected by cross-jurisdictional externalities.

In contrast, public choice theorists advocate federalism because it provides an institutional arena for different levels of government to interact strategically to maximize political returns and economic rents. Deeply anchored in these tenets, the literature on market-preserving federalism provides a prominent example of this line of reasoning: federalism is market friendly because it restrains the predatory nature of the public sector through citizens' ability to punish incumbents either with their ballot or "with their feet."[6]

As federalism sets incumbents at different levels of government to compete for economic factors, the interplay between mobility and the behavior of subnational leaders becomes critical. Welfare economists and public choice theorists see in the mobility of economic factors an important engine behind the alleged benefits of federalism, though again, from rather different angles. For welfare economists, as illustrated by the seminal work by Tiebout (1956), the mobility of citizens and capital is for the most part a mechanism of preference revelation for incumbents who are assumed to be driven only by aggregate welfare considerations.[7]

For public choice theorists, both the ability of productive factors to exit and the risk of a welfare magnet effect work to constrain Leviathan's economic appetite. In sum, the interplay between federalism and factor mobility promotes economic efficiency because the reduction in the size of government is essentially reflected in lower levels of distortionary redistribution. The key implication of these analyses is that the informational and efficiency advantages of federal structures come at the expense of the social union. More inequality becomes, yet again, the price tag of better markets.[8]

In addition to this largely normative literature, the conventional view also draws on empirical work on the origins and evolution of the welfare state as well as on the more recent increase in attention to the institutional foundations of inequality (Alesina and Glaeser 2004; Persson and Tabellini 2003). The constraints on redistribution here do not come just from the expected behavior of economic factors, but from the political system itself. Federalism institutionalizes a system of veto points that enables defenders of specific territorial interests to object to, and eventually block, nationwide redistributive

[6] Buchanan (1950, 1995: 19–27); Buchanan and Wagner (1970); Inman and Rubinfield (1997: 73–105); Weingast, Montinola and Qian (1995); Qian and Weingast (1997: 83–92); Weingast (1993: 286–311; 1995: 1–31).

[7] Provided that the demand for local public services is income elastic, that these services are financed by income taxes (Oates 1972, 1991), and that there is perfect mobility, Tiebout's model predicts that communities become homogeneous in income and heterogeneous in capacities. For a systematic discussion of the usefulness and analytical limitations of Tiebout's work, see Bewley (1981: 713–740); Panizza (1999: 97–139); Rose-Ackermann (1983: 55–85); Stiglitz (1983: 17–55).

[8] For discussions on the relationship between mobility and redistribution, see Crémer et al. (1996) and Epple and Romer (1991).

endeavors. As such, fragmented political structures crystallize multidimensionality, thereby priming second dimensions (such as identity, territory, or race) and limiting the feasibility of large redistributive coalitions (Iversen 2006).[9] A similar logic guides many analyses of welfare policy reform in North American federations, where scholars tend to interpret proposals in favor of decentralization as masked efforts to curtail the welfare state.[10]

More recently, a third stream of research has come to confirm the association between inequality and decentralized political institutions, though this time reversing the direction of causality. Starting with the seminal work by Bolton and Roland (1997), a number of contributions have emphasized the shape and territorial specificities of income distribution as a key determinant of political integration and constitutional choices in federations (Alesina and Spolaore 2003; Beramendi 2007; Sambanis and Milanovic 2009; Wibbels 2005b). The argument goes as follows: federalism and decentralization are associated with particular distributive outcomes not because they exogenously generate them[11], but because distributional concerns play a fundamental role in shaping the organization of fiscal structures in political unions.[12]

There is no doubt that these lines of research have provided important insights on both the economics and the politics of decentralization. Moreover, there is much to like about the elegance and parsimony of these approaches to the association between federalism, decentralization, and inequality. However, they are unable to account for the observable variation in fiscal structures across political unions. Figure 1.1 provides an overview of the relationship between fiscal structures and inequality in political unions. In the left panel, the x axis ranks countries according to their level of decentralization of interpersonal redistribution, and the y axis ranks countries according to their level of disposable household income inequality (Gini coefficients).[13] In turn, the

[9] For studies on the United States, see; Amenta and Carruthers (1988: 661–678); Pierson (1995: 449–478); Quadagno (1994); Skocpol (1992); and Skocpol and Orloff (1984: 726–750) as well as the recent insights from institutional economic history by Alston and Ferrie (1999: 49–74, 118–152). For a recent formalization on the determinants of the welfare state in the United States see Alesina, Glaeser, and Sacerdote (2001); and Alesina and Glaeser (2004). For similar, albeit older, insights see Lowi (1984: 37–55). For quantitative cross-national comparisons, see, among others, Hicks and Kenworthy (1998: 1631–1673); Hicks and Swank (1992: 658–674); Huber, Ragin and Stephens (1993); and Huber and Stephens (2001).

[10] This claim builds upon devolution to the provinces/states in Canada and the United States. On the former, see Banting (1987, 1992: 149–170, 1995); Courchene (1993: 83–135; 1994); and Kenneth (1998). On the latter, see Peterson (1995); Peterson, Rom and Scheve (1998); and Volden (1997: 65–97).

[11] As an example, see the logic underlying the conclusions Huber, Ragin and Stephens (1993: 711–750); and Huber and Stephens (2001) draw from their index of constitutional structure.

[12] This literature is part of a broader trend that places tensions associated with the distribution of income as major determinants of institutional choices such as the nature of the political regime (Acemoglu and Robinson 2006; Boix 2003), or the design of electoral rules (Cusack, Iversen and Soskice 2007; Rogowski and MacRae 2008; Tichi and Vindigni 2003).

[13] Household income per equivalent adult as defined by the Standardized Income Distribution Database (Babones 2008) and the Luxembourg Income Study.

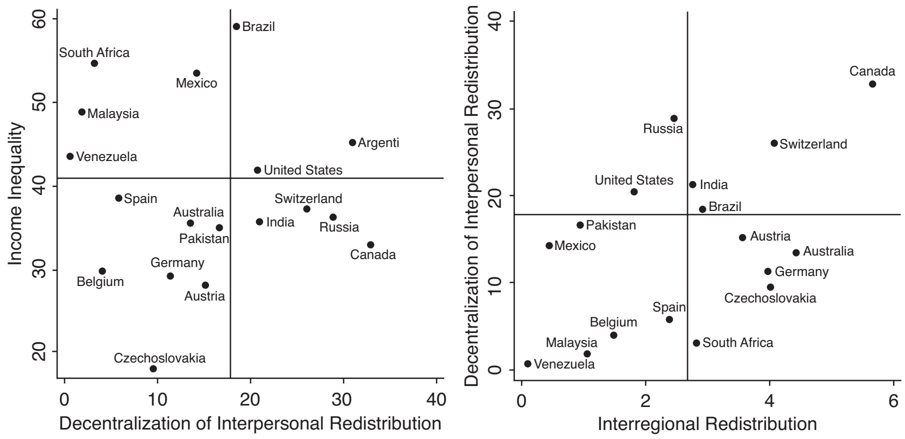

FIGURE 1.1. Fiscal Structures and Income Inequality in Political Unions

right panel ranks countries along the two dimensions of fiscal structures identified previously, namely, interpersonal and interregional redistribution.[14] Thus, the y axis ranks countries along the same indicator of decentralization of interpersonal redistribution (x axis in the previous panel), and the x axis now ranks unions according to their level of interregional redistribution.

Two important points follow from the left panel in Figure 1.1. First, the United States, the case on which the conventional view is largely based, is indeed the most prominent example of a positive association between fiscal decentralization and income inequality. Yet it clearly seems to be more the exception than the rule, particularly among advanced industrial political unions. Canada, Belgium, Germany, Austria, and Spain offer a wide range of variation in both distributive outcomes and levels of decentralization of interpersonal redistribution.[15] Moreover, the variation becomes even larger if developing federations are considered.

This diversity of outcomes, largely at odds with the conventional view, motivates the leading question in this study: why is it that some political unions show less redistribution and more inequality than others? The key, I argue, lies in the organization of their fiscal structures. A comparison between the two panels in Figure 1.1 illustrates this point. The top left quadrant of the left panel includes a group of countries (Venezuela, Malaysia, South Africa, Mexico, and Brazil) with exceedingly high levels of inequality and very little decentralization of interpersonal redistribution. Interestingly, this subgroup also shows very low levels of interregional redistribution as reflected by their concentration in the bottom left quadrant of the right panel.

[14] Interregional distribution is defined as transfers to other levels of government as a percentage of GDP. For additional details on sources, see Appendix D.

[15] See also Lindert (2004); Linz and Stepan (2000); Obinger, Leibfried and Castles (2005).

Unsurprisingly, this subgroup of countries shares one other feature – the underdevelopment of effective social and public insurance policies at the national level (Beramendi and Diaz-Cayeros 2008; Wibbels 2006). Variation increases as we move beyond this quadrant. Remarkably, even in the noisy context of these bivariate relationships, a discernable pattern emerges. The incidence of inequality appears to be larger in those unions with high levels of decentralization of interpersonal redistribution and low levels of interregional redistribution.

In contrast, those unions able to combine relatively decentralized systems of interpersonal redistribution with significant efforts to redistribute resources across territories, such as Canada, manage to avoid the *distributive curse* associated with the conventional view. Put simply, the organization of fiscal institutions within political unions dictates how egalitarian these are. Logically, then, any solution to the puzzle of diversity of outcomes lies in achieving a better understanding of the origins and evolution of fiscal structures themselves.

A careful consideration of several cases helps substantiate this claim. I shall return to Roosevelt for a moment. Following the Great Depression, distributive tensions among states in the United States and among provinces in Canada became starker, triggering a myriad of competing proposals for institutional adjustment on both sides of the frontier. Interestingly enough, similar regional patterns of inequality yielded very different responses in the two North American federations. While Canada developed a centralized system of unemployment insurance in 1941, the U.S. Social Security Act (1935) included provisions leaving the ultimate design and implementation of unemployment insurance in the hands of the states.[16] This diversity of responses is puzzling because the two unions confronted the Depression from very similar positions. During the first decades of the century, the United States and Canada were alike in their approach to the issue of unemployment. In fact, until the Depression their systems of social protection were equally fragmented, both politically and organizationally. In addition, both systems were exposed to a similar set of external influences. Hence the question: why did the paths of these two rather similar systems diverge during the late 1930s and early 40s? Moreover, the case of the United States is particularly interesting because it shows relatively poorer regions actively resisting and ultimately blocking a centralized system that would have generated significant transfers toward them. This case, and others such as present-day Scotland, present the puzzle of low income regions opposing integration despite significant potential transfers. In turn, the

[16] Though eventually transformed into a hybrid regime (Lieberman 1998; Mettler 2002), the U.S. system remained one in which states can differ in terms of prerequisites, generosity, and duration of unemployment benefits. Throughout most of the twentieth century this has been one of the most prominent *small differences that matter* to explain why distributive outcomes differed between the two North American federations (Banting 1987, 2005; Card and Freeman 1993).

Canadian response presents the puzzle of rich regions endorsing a centralized fiscal structure despite significant income losses.

The contrasting dynamics in the United States and Canada are echoed more recently in the EU, Spain, and Germany. As the European Economic Community evolved from an entity built primarily around geopolitical considerations toward a progressively integrated market, the question of whether fiscal integration ought to parallel monetary integration has gained salience. A large empirical literature substantiates Krugman's concerns about the unbalanced nature of policy integration in the EU (Scharpf 1998). Regarding fiscal and social policy, the EU remains pretty much a "hollow center" (Pierson and Leibfried 1995; Streeck 1995). The European center engages only in modest attempts to ameliorate inequality among European citizens and only moderately constrains interregional differences in terms of fiscal resources. As a result, the EU is today a very inegalitarian union. Why?

Germany provides important counterexamples to the dynamics in the EU in particular, and the conventional view more generally. Germany is the most obvious example of a large and highly redistributive welfare state and large levels of interregional redistribution being perfectly compatible with federalism and decentralization (Manow 2005). Indeed, Germany's political evolution after Reunification shows a federation incorporating five new poorer *länder* and twenty million new citizens. The system did not change, despite a massive alteration in the geography of income and labor markets. It also assimilated the new members in a short period of time, triggering an unprecedented redistributive effort from the West to the East. The German experience is puzzling for its institutional stability in light of major structural change, and for the fact that rich regions endorsed an assimilation strategy involving large levels of redistribution toward poorer members.

Finally, the Spanish experience is probably the one most clearly at odds with the predictions of the consensus view. Over the last two decades of the twentieth century the Spanish welfare state has expanded at the same time that the state structure has undergone a far-reaching process of political decentralization (Espina 2007; Gallego, Goma and Subirats 2003). While virtually every important public policy in Spain, including health, education, infrastructure development, policing, and industrial development is now decentralized, the bulk of social security transfers expands and remains in the hands of the central government (Subirats and Gallego 2002). If distributive tensions associated with the geography of inequality are to bring about more decentralized fiscal structures, as the literature on endogenous institutions contends, what explains the remarkable levels of resilience of Spain's central government against the notion of engaging a territorial partition of the welfare state? Why has fiscal decentralization in Spain taken the form of reticent partial concessions on the revenue side and virtually no concessions on the expenditure side (Espina 2007; León 2007; Moreno and McEwen 2005)?

More broadly, why does European inequality map neatly onto anemic social effort at the EU level, while geographic distribution of inequality seems weakly linked to fiscal dynamics in Spain and Germany?

OVERVIEW OF THE ARGUMENT

As a strategy to solve these puzzles, this book analyzes the origins and evolution of fiscal structures in political unions. Political unions organize their fiscal systems according to one of three designs: a *centralized* design (C) in which the national government controls income taxes and transfers as well as the allocation of resources across regions; a *decentralized* design (D) in which regions control income transfers and taxes and there is very little redistribution between regions; and, finally, a hybrid design (H), in which a partially decentralized system of interpersonal redistribution coexists with significant levels of interregional redistribution. These are obviously ideal types in a continuum in which actual unions fall in different positions. The situation in Spain in the aftermath of its democratic transition exemplifies a political union with a centralized fiscal structure (C). The European Union is a case of a very decentralized fiscal structure (D). Finally, Germany's fiscal structure during the post-war period offers an example of a hybrid regime (H).

In explaining variation among these designs, I build on the premise that electoral concerns drive the choice of fiscal structures (O'Neill 2005). An important part of gaining and retaining office lies in acquiring a position to forge successful electoral coalitions, an endeavor for which fiscal redistributive policies constitute a powerful tool. Thus, political elites will support the specific fiscal structure that best serves their electoral interest. This book highlights two factors shaping politicians' choices between the three types: the combined effect of economic geography and the organization of political representation on the one hand, and the role of mobility as a source of cross-regional economic externalities on the other. These factors, I argue, are the mechanisms driving the political geography of inequality. I outline the argument in four steps.

Decentralizing fiscal structures matters for inequality because it activates the underlying economic geography of the union.

The distributive consequences of allowing subnational governments to control taxes and transfers are a function of the preexisting levels of inequality between and within regions. This being the case, it is reasonable to assume that political actors are aware of the structure of inequality within the different territories and their relative position within it, from which they derive an expectation about the distributive implications associated with any alternative institutional design. Put simply, actors deciding on the design of fiscal structures are at the same time making a choice regarding income redistribution. By implication, the prospect of any institutional change concerning the territorial allocation of the powers to tax and transfer triggers a distributive conflict both between and within units. This conflict unfolds along two dimensions: income