ELSEVIER European Economic Review 39 (1995) 751–758

EUROPEAN ECONOMIC REVIEW

The Political Economy of Fiscal Discipline

Togetheror separately? Issues on the costs and benefits of political and fiscal unions

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Abstract

Around the world one observes a tendency toward political separatism. The economic literature generally (but not always) emphasizes several benefits of large fiscal (and, therefore, political) jurisdictions. In this paper we discuss several politico-economic arguments which reconcile this tension between "normative" economic models and empirical observations.

Keywords: Fiscal federalism; Political integration; Separatism

JEL classification: H1, H7

1. Introduction: The question

Many countries around the world are considering whether to break apart, stay together or join in federations. The current process of border rearrangements is rather exceptional for modern peacetime history.

Generally, one can detect a tendency toward separatism and regionalism. For example, in eastern Europe several countries have disintegrated (Yugoslavia, the

* Corresponding author. This research is supported by a grant from the National Science Foundation.

SSDI 0014-2921(95)00082-4

former Soviet Union, Czechoslovakia); in Western Europe and North America movements for regional autonomy are becoming more vocal (Spain, Italy, Belgium, Quebec). The process of European integration is struggling: one senses that the public is less enthusiastic than political leaders about European integration. In Africa ethnic conflicts threaten the territorial integrity of several countries, so that several commentators wonder whether the preservation of current national borders in this region is not too costly. [1] One of the very few movements in the opposite direction is the reunification of Germany which, however, appears more costly and problematic than many had anticipated.

While political separatism is rampant, free trade and economic integration are also on the rise. The combination of economic integration and regional separatism in Europe leads several observers to question the future of the current nation-states, 'threatened' by supernational economic integration and regional conflicts. Drèze (1993), for instance, proposes a 'Europe of regions', namely a continent of economically integrated but politically independent regions.

The critical question is whether regions (or countries) should form political unions, or, beyond free trade in goods and inputs, large political unions are unnecessary and possibly counterproductive. In several parts of the world this question is really burning. For instance, should the international community and the Canadian citizen view favorably Quebec separatism or not? Should the international community support the effort of ethnic minorities to gain independence?

Fiscal issues in general, and redistributive issues in particular are important determinants of decisions concerning secessions, confederations and border redrawing. In fact, the definition of borders and the political mechanisms which lead to fiscal decisions within given borders greatly influences the final distribution of the fiscal burden and of the fiscal benefits. The existing literature, and particularly the literature on fiscal federalism, has put forward several arguments in favor of relatively large jurisdictions. Two arguments rely on the public good aspects: (1) a large jurisdiction can benefit from economies of scale in the production of public good; [2] (2) it can internalize externalities that lead to problems of tax competition. [3] The literature on redistributions suggests two additional arguments: (3) a large redistributive system encompassing several regions or countries can insure against region or country specific shocks; [4] (4) if redistribution has a public good dimension, because taxpayers care about the welfare of others, there will be too little of it in fragmented jurisdictions. [5]

[1] For instance, see the *Economist*, September 10–16, 1994.

[2] See Casella and Feinstein (1990) and Casella (1992).

[3] See Epple and Romer (1991) and the references cited therein.

[4] Sachs and Sala-i-Martin (1992) and Persson and Tabellini (1992).

[5] Brown and Oates (1987), and Pauli (1973).

On the other hand, the literature on local public goods emphasizes the advantages of decentralization when differentiated bundles of public goods can be provided efficiently in different localities and individual mobility is costless. [6] The Tiebout model and its extensions, however, do not necessarily have implications concerning the size of *national* boundaries. As a matter of fact, a social planner at the national level could always replicate the Tiebout solution and provide differentiated local public goods to different communities within the national boundaries. [7]

Overall, the normative literature using the 'social planner' framework points to the benefits of centralized fiscal decisions in relatively large political jurisdictions. [8] We perceive a certain tension between the implications of the 'normative' theory and the reality of country formation and (dis)integration. Our view is that social planner models and even some median voter models underemphasize redistributive problems and the role of 'diversity' amongst individual and groups and amongst existing institutions of different regions and countries. [9]

2. Some possible answers: A critical trade-off

In our view, the critical trade-off is that the benefits of large political jurisdictions come at a cost, due to the necessity of keeping together individuals with different interests, preferences, culture, and history. [10]

In what follows we discuss how this fundamental trade-off plays out in three different cases. We feel that these three examples move some steps toward explaining this apparent tension between the predictions of social planner models and reality. The first example considers the public good provision aspect of fiscal policy. The other two consider redistributions: one emphasizes differences amongst individuals, the other one differences in institutions.

2.1. Public goods provision: The trade-off between specificity and economies of scale

Alesina and Spolaore (1994) study the problem of country formation and secessions by focusing on a specific trade-off between economies of scale in the provision of public goods and 'closeness' of the public good to individual preferences.

[6] The classical reference is Tiebout (1950). See also Rubinfeld (1987) and Epple and Romer (1991). The latter is a variant of the classical free-rider problem.

[7] See Seabright (1993).

[8] In the case of redistributive fiscal policy, the observation generally applies also to several models with voting.

[9] An exception is Bolton and Roland (1993) who provide an intriguing analysis of secessions by means of majority voting in countries with different levels of income.

[10] In a *Wall Street Journal* article in 1991, Barro succinctly emphasizes the same trade-off.

The per capita cost of any non-rival public good decreases with the number of taxpayers who finance it. However, taking advantage of the economies of scale in relatively large countries comes at a price. The price if the loss of "specificity" of public goods. In a large country with a diverse population it is more difficult for a single government to satisfy the preferences of everybody. Thus, in a large country, certain individuals and groups are 'far' in a preference dimension, from the type of government of their own country. Without some assumptions about the 'geography' of a country, the latter would look like a club, namely a collection of individuals with similar preferences but no constraints in their location. In order to obtain the realistic feature of geographically connected political jurisdictions, one can make two types of assumptions: (i) impose administrative costs on disjoint countries; (ii) impose a correlation between geographical location and preferences on the type of government.

Alesina and Spolaore (1994) adopt the second alternative and assume that geographical distance and preference distance are perfectly correlated: if two individuals are far from each other geographically (and individuals are immobile) they are also far in preferences.

For the purpose of the present paper, Alesina and Spolaore's main results are two. First, they show that a benevolent world social planner chooses to have fewer and larger countries than the democratic equilibrium solution. The social planner can choose the number and size of countries that optimizes on the trade-off between economies of scale and population diversity by compensating (with lump sum taxes and transfers) individual who are 'far' from the government. In a democratic 'market' equilibrium, where unilateral secessions are permissible and a majority of each country's citizens has to agree on its borders, countries are smaller and more numerous than in a social planner world. In fact, the tax-transfer schemes which enforce the social planner optimal solution would not be supported in a democratic equilibrium. In other words, to keep relatively large countries together, one needs a redistributive scheme which is very difficult to implement; thus the equilibrium solution is to have smaller countries.

The second result concerns the relationship between country size and economic integration. In a world of trade barriers and economic semi-autarky, country size has an important economic meaning, since it influences to the size of the market. This consideration introduces an additional incentive to form large countries. With increasing economic integration, this incentive vanishes, thus the equilibrium size of countries shrinks: more economic integration and freer trade should be accompanied by political separatism.

The assumption concerning the coincidence of geographical and 'performance' distance implies excluding ethnic minorities. The introduction of ethnic minorities into this model is likely to reduce even more the equilibrium size of countries. In fact, an ethnic minority may choose to form a small independent country, bearing the costs of its diseconomies of scale, in order to separate from the ethnic majority. Clearly one has to consider other factors, such as migrations, the reaction of the ethnic majority, etc., but it is counterintuitive to imagine that in the Alesina-Spolaore model one would find larger countries if one allowed for ethnic minorities.

2.2. *Redistributions: Economic risk and political risk*

With a social planner, centralization in large jurisdictions facilitates risk sharing: redistributive schemes transfer income from individuals hit by a favorable shock in favor of their less fortunate fellow citizens. These transfer programs indirectly redistribute from one region to another in cases of region specific shocks, namely, in cases where the 'lucky' individuals are largely concentrated in one economic region. [11] Thus, two or more regions may share some economic risk by centralizing their redistributive systems. For instance, when the two regions are identical, except for the fact that their shocks are not perfectly correlated, a move toward centralization of fiscal policy is a Pareto improvement. The question is whether this implication also holds in models where decisions on fiscal policy are reached by majority rule.

Alesina and Perotti (1994) consider two countries which are hit by idiosyncratic shocks, with a certain distribution of income within each country. If these countries maintain a separate fiscal system, they cannot insure each other; the amount of 'economic uncertainty', i.e. the uncertainty over individual income caused by the exogenous economic shock cannot be dampened. [12] On the contrary, if the two countries form a fiscal union, they can reduce economic uncertainty by mutual insurance through the interpersonal redistributive system. More specifically, assume that after the shocks occur, citizens in the centralized country vote, by majority rule, on a proportional income tax, which is redistributed lump-sum. On balance, the unlucky region will receive positive net transfers. In general, the poor citizens of the lucky country will still receive net positive transfers, and the rich of the 'unlucky' country may still receive negative transfers. In other words, redistribution goes from the rich to the poor and, indirectly, from one country to the other, since the lucky country is richer.

Even though the centralized regime reduces the 'economic uncertainty,' it may increase the 'political uncertainty.' Since the citizens of *both* countries vote on the same policy instrument, for any given shock there is more dispersion in the dispersion of income (thus, of preferences) of the population: the uncertainty over the tax increases, relative to the decentralized regime. In more colorful terms, the centralized regime reduces the economic risk, but may increase the political risk. As a result, everybody, or, at least, a majority, may be worse off. In fact, Alesina and Perotti (1994) show that for a wide range of parameter values a majority of

[11] The realistic assumption underlying these models is that private insurance is not available.

[12] Obviously, we are referring to an economy-wide shock.

voters in *both* countries would object to a fiscal union, and for an even wider range of values at least one country would object. They also show that the range of parameter values for which the two countries choose to be apart is larger the more 'polarized,' in a certain sense, is the distribution of income within each country.

The basic intuition is closely related to the models with public goods described in the previous section. In both cases, an increase in the size of country implies a trade-off between 'common good' (insurance here, a public good before) and the increase in heterogeneity (of realized income here, of cultural 'distance' before).

2.3. Redistributions: institutional differences

Different countries may have different labor market institutions, different types of bureaucracies or even different levels of 'social capital': that is, different levels of civism and concern for the public good. For instance, the amount of fiscal evasion appears to vary greatly even amongst relatively similar countries, such as the OECD group. [13]

Perotti (1993) presents a model in which he focuses on the effect of differences in labor market institutions on the incentives to create fiscal unions. Consider two countries contemplating the possibility of forming a political and fiscal union. In the first country the labor market is perfectly competitive while, in the second, a monopoly union sets the wage, taking he labor demand function as given. In a centralized system all tax revenues in the two countries are pooled and redistributed to all eligible agents. Because the first country has no unemployment, the unionized agents in the second country can use some of the tax revenues of the first country to subsidize unemployment at essentially no cost. Instead, in a decentralized system, all countries have to rely on their own resources to finance redistribution. This limits the resources available to subsidize unemployment in the only country where it exists. Thus a decentralized regime leads to a more efficient allocation of resources, by limiting the resources available to those agents who have an interest in distorting the economy. [14] Perotti then endogenizes the fiscal regime by considering the positive question of which system would be adopted by majority voting in the two countries. That paper shows that the more inefficient regime can be favored by a majority of agents in *both* countries, even if it leads to a systematic transfer of resources from one country to the other and to lower aggregate production.

Differences in labor market structure is only one example of institutional difference. A similar intuition applies to other institutional differences, such as the

[13] For obvious reasons, data on fiscal evasion are hard to come by. However, this conclusion is consistent with many studies on fiscal evasion in various countries; see Greenfield (1993).

[14] Capital mobility can exacerbate, rather than attenuate, the relative inefficient of the centralized regime.

administration of the social security system. Consider the case of a fiscal union in which the tax rate, and thus the expenditure on social security, is decided at the federal level, but regional governments have a certain amount of discretion in the administration of the system. By being more or less generous in accepting applications, a local government has a potentially large leverage on total redistributive expenditures within its boundaries. [15] Local governments do make use of this leverage to enhance their political support. The case of Italy is striking; the average ratio of disability pensions to old-age pensions in the whole country in 1978 was 43%, but it was 250% in the South, and 669% in the Enna province in Sicily. [16]

The message of the paper is as follows: when the social security system is used for political purposes to different degrees, in different regions, or it is administered with different criteria, centralized funding of the system can generate an inefficient outcome. Regions with looser administrative standards can 'free-ride' on the tax revenues collected in other regions to pursue their generous use of social security benefits. Conversely, when the funding of redistributive expenditure is decentralized, local governments can rely only on local sources to fund their social security programs. This automatically constrains the use of social security for patronage.

Empirically, these issues of institutional differences are very relevant. For instance, issues of different standards in implementing social security systems and their effects on budget deficits are crucial in the discussion about European union. Differences in the administration, efficiency, and generosity of welfare systems across regions in Europe are quite large and unlikely to be explained simply by demographics and other purely economic factors (Emerson, 1988).

Similar considerations apply to the U.S., where one observes substantial variation in the administrative standards of different states. For instance, in 1980 the AFDC benefits for a family of three, with no income, was five times higher in Vermont than in Mississippi ($492 versus $96); a difference hard to explain by income differences between the two states.

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[15] The literature is fairly unanimous on this point: local governments should participate in the *administration* of redistributive programs *funded at the federal level*, particularly means-tested ones, because they possess informational and other administrative advantages over the central government (Ladd and Doolittle, 1982). In the U.S., about 70% of expenditures connected to welfare programs is administered by local governments.

[16] See Emerson (1988).

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