

**The Redistributive Foundations of Federal Bargains: A Comment on
Rodden's "Federalism and Inter-Regional Redistribution"**

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“Federalism and Inter-Regional Redistribution” stands out as an important, original contribution to the political economy of federalism. In that chapter Jonathan Rodden makes two important contributions – one empirical, the other theoretical -- to the study of the political economy of federalism. In the first place, he offers comparable data on the extent of inter-regional fiscal flows in nine federations by looking at the size of intergovernmental grants and their impact over the per capita income of regional units. The European Union, India and the United States engage in little inter-territorial redistribution. Argentina and Brazil have some redistribution – but hardly of a progressive nature. Finally, Australia, Germany, Spain and Canada show a notable level of redistribution.

In the second place, he sketches a new theory of the political and economic mechanisms that explain variation in inter-regional redistribution across federations. As Rodden rightly notes, current explanations are inadequate. Pure economic theories of fiscal federalism cannot explain most of the cross-national variance in fiscal flows. Culture-based explanations (emphasizing differences in national commitments to solidarity) do not match the historical dynamics of the cases. Finally, straightforward redistributive stories à la Meltzer-Richards predict the opposite of what the chapter finds out: unequal federations actually redistribute less than equal ones.

Jonathan Rodden’s political-economic theory of federal bargains unfolds as follows. In all federations there is a potential coalition of low-income units interested in imposing redistributive policies. However, that potential redistributive coalition only forms and achieves its goals under a particular institutional configuration: a parliamentary system, which facilitates the construction of cohesive national parties (thus paving the way for higher levels of redistribution); the proportional representation of electoral districts (as opposed to malapportioned upper houses); and large electoral districts (since small electoral districts generate a more compressed distribution of district income medians at the national level and

hence lower the demands for redistribution). In turns, all those institutions are the outcome of a particular bargain among the members of the federation, driven by some calculations of rich and poor regions about their ideal level of redistribution. Rich regions tend to block redistribution unless there are (mainly trade-related) gains to be made from the federation that require buying out poor regions through compensatory mechanisms – those compensatory commitments are then built into the federal constitution.

To put it shortly, Rodden’s chapter reminds us that we will only understand the nature and performance of federal systems if we see them as an interlocking structure of economic interests and outcomes and of political and institutional devices. This naturally forces us to dwell on the problem of ‘endogenous federal bargains’, that is, the causes which determine and sustain federal agreements. In the rest of this comment, I probe Rodden’s argument by sketching a simple model that integrates his insights on the formation (and maintenance) of federations and the current literature on endogenous federalism and political integration. The model rounds off Rodden’s insights while alerting us to the need of at least adding three additional factors to make sense of the dynamics of redistribution across federations: the security needs of regions, the endogenization of the choice of trade integration to domestic conditions, and the need to distinguish between the creation of federations *ex nihilo* and the renegotiation of existing unions.

Endogenous Federal Bargains

To start with, assume a territory with several regions that are initially independent but that at some point entertain the possibility of establishing some kind of economic and political union.¹ The initial territorial compact to establish a union necessarily includes two

¹ I employ the term ‘political union’ rather than ‘federation’ because the former is a more encompassing one – ranging from Jacobin states to supra-national trade agreements or military alliances. By contrast, the

things: first, an agreement over which assets regions pool together; second, setting up a joint political authority to execute the agreement. The latter also implies establishing a common procedure to decide over daily policy.

Because the institutions of the union are the only mechanism to execute the initial contract, the extent of asset-sharing and the strength of central institutions (to be defined shortly) covary in general terms: the more extensive the agreement is (the more assets are put in common), the stronger common (or central) institutions of the union tend to be. ‘Minimal’ agreements in which regions hardly share anything come with common institutions of a ‘confederate’ kind where every region keeps its right to veto every decision. As regions decide to pool more assets together and then transfer their administration to a central institution, the latter becomes stronger vis-à-vis each individual region, that is, the power of a single region over common decisions declines. Broadly speaking, the loosest (weakest) type of union is governed by a principle of unanimity. Complete integration happens when the union sets policy by simple majority rule (of individual voters).

The extent of political (and fiscal) integration (and the level of inter-regional redistribution) will be driven by two broad forces: the risks of exploitation of any given region by the majority of its partners in the union; and the potential gains unions bring to their potential members.

The risk of exploitation increases with the degree of income heterogeneity among regions. More specifically, and following standard models of optimal taxation, wealthy regions (those with an income above the general median income) will have to pay some transfers to the poor regions (those with incomes below the federal median income). Moreover, the more divergent the standards of living across regions, the larger those transfers

term of federation is far narrower and does not strictly include some of the cases Rodden chooses, such as Spain.

from wealthy to low-income regions will be (Meltzer and Richards 1981).² Hence, based on pure fiscal calculations, wealthy regions should oppose political integration – totally or by establishing institutions that give them the power to veto any deviations over the initial agreement). Rodden’s findings in Section 3 fall in line with these theoretical expectations: first, inter-territorial distribution is strongest in those federations where decision-making procedures are closest to the principle of proportional representation of territories; second, the most unequal federations have the weakest central institutions

The gains that unions may bring to their potential members are of three kinds. First, they bring insurance gains: risk-averse regions may benefit (even if they rich on average) from establishing a strong union that smoothes some inherent income volatility or some negative shocks. Second, political unions can accrue important security, peace-related gains. Unions suppress (in principle) the security dilemma that lingers over its regions before integration. They also reduce the threat of military conquest by neighbors. Those gains are conditional on the world environment. In a Hobbesian world, where countries are manifestly aggressive (due to the nature of their institutions or to their type of political economy), political unions are a must. In a Kantian world, formed by peace-loving republics, they are dispensable. Finally, strict economic gains: a larger market for each region’s producers, reduced transaction costs from a common currency and so on.

The Need for a More Complex Theory of Trade Interests

In the existing literature on economic integration, those latter (economic) gains are taken to be a direct function of the world level of market integration: the incentives to integrate decline as the world becomes more open or globalized (Alesina and Spolaore 2003).

² In a more complex story, à la Bolton and Roland (1997), one could also consider regions with different internal income distributions and therefore with individuals that may have different preferences about the right type of union.

However, as Rodden hints at in his historical evidence, the impact of economic integration is a more complex one. The gains from establishing a union are never uniform across regions: they vary with the level of development and the factor endowment of each region. Let me develop more explicitly Rodden's intuitions. I do so by looking first at rich regions. Then I examine the case of poor regions.³

In a "mercantilist" world, that is, one in which there are barriers between the union and other countries, the position of wealthy regions will vary as follows. Abundant-factor regions (that is, regions where the decisive voter is the owner of an abundant factor) benefit from more integration because the latter creates a larger market and therefore higher returns to that factor. However, that process of integration may increase inter-regional inequality and therefore raise taxes on those wealthy regions. Depending on which of the two effects prevails, those regions will favor or oppose a deeper political union. By contrast, wealthy but scarce-factor regions will be against any integration: they see their returns decline and they must also pay some transfers toward poor regions.⁴

If the world as a whole is an open one, the factor-abundant region has no interest in the federation, provided it is also a factor-abundant region in the world context since it now has access to what it wants, i.e., large markets. But if its decisive voter owns a scarce factor, the region will support the federation conditional on closing the latter to the world. (This seems to be the kind of case Rodden has in mind when he refers to the American federation in the nineteenth century, with a nascent domestic industrial sector willing to 'compensate' agriculture in exchange from protection against foreign industries. I would like to add the European Union and its agricultural policy here.) The bargain to create a protectionist federation requires some kind of compensatory deal – a transfer from the scarce-factor region

³ Throughout the discussion I assume a Heckscher-Ohlin trade model.

⁴ Naturally their returns may fall so much that they may even become net receivers of transfers.

to the abundant-factor region. Given the income losses that come from closing markets (at least in standard trade models), such a deal is only possible if the latter is richer or technologically more advanced than the former: this allows the former to make some direct payments or to make some technological transfers to the poorer one. (In other words, the subsidization of French farmers would have been impossible without the existence of BMW and the likes.)

Consider now the case of poor regions, i.e., those with per capita income below the federation's median. We know that they fiscally benefit from higher, stronger forms of integration. Yet, here again, trade issues complicate the picture. In the context of a mercantilist world, an abundant-factor (but income-poor) region will push for a strong federative bargain. A scarce-factor one will only do so if fiscal flows compensate its lost returns. (The possibility of compensating richer regions in exchange for a protectionist deal seems far-fetched). In an open world, an abundant-factor region continues to support a federal agreement because it stands to gain from tax inflows. A scarce-factor region will only support it if those fiscal flows exceed any economic losses through trade.

Renegotiating Unions

To fully understand the dynamics behind the maintenance and evolution of federal bargains (and the extent to which they are more or less redistributive), it is important to distinguish between the creation and the renegotiation of unions – for two reasons. First, the point of departure (the status quo point to which failed negotiations revert) is different in each case. At the moment of the creation of unions all its future components are independent – they have the power to veto any agreement that they expect will be harmful to their interests. By contrast, in an existing union the renegotiation is conducted through common procedures: short of exercising an exit option, all territories have to convince a majority of

the members of the federation to change the current bargain. Second, in pre-existing unions there are already central institutions that have both a particular interest and the capacity to sustain that union: this imposes an additional cost in the renegotiation of any territorial deals.

The renegotiation of political (federal) contracts takes place under two broad circumstances: democratization and exogenous economic shocks. It happens in those pre-existing political unions that move from authoritarian regimes – in which only a minority of the members had a voice in the choice of institutions – to democratic regimes. Ideally, a shift to democracy implies that the regions in the unit may have the right to decide in a voluntary fashion the type of institutional arrangement that should govern them. Unhampered by dictatorial institutions, they should strike the deal that suits them better. But the existence of central institutions makes this hard to achieve in practice. By way of example, take the case of a democratic transition in a country located in a Kantian, free-trade continent: we according to the theory just outlined, we should expect wealthy regions to secede at the time of democratization of the country to which they belong(ed) with a high probability. Yet this assumes away the deadweight of the political status quo: at the moment of democratization, there are already in place key political forces and institutions (the central government, the military) that can threaten a seceding unit with a reversal to the authoritarian deal if it does not tone down its demands and insists on separation. Hence, unless those central institutions implode at the time of the transition (as in Russia or Yugoslavia in the early 1990s), radical renegotiations leading to the “preferred” contract space (the one based on pure economic and peace considerations) will not happen. To put it in more general terms, whenever there are gradual transitions to democracy, the new institutional bargain will fall mid way between the authoritarian status quo and the political outcome that would have taken place if all the regions had come to the negotiating table for the first time. In turn, that means that the resulting ‘federation’ will continue to experience considerable instability in the medium turn

– as the old institutions lose their grip on the country (for instance, the army’s relevance fades away), those regions that were unsatisfied with the transition deal will insist again on changing the rules of the game. This explains a great deal of the political instability of Spain in the last decade or so.

External Shocks and the Stability of Political Unions

Renegotiations also happen when the exogenous conditions that shaped the initial deal (inequality within the union, global market integration, military threats, income volatility) shift.⁵ In that instance, political unions may tend to change -- but they will do in a biased or asymmetrical way.

Start with a case in which there is a shock which makes wealthy regions experience some additional benefit from belonging to a political union: for example, a rising power threatens its neighbors or inequality within the union declines. Had those conditions occurred in the absence of a federal pact, the wealthy regions would have accepted a much stronger or deeper federal system than the current one. At this point, however, and provided they had structured the initial institutions adequately (to protect their position), they will have all the incentives to block any demands from the poorer regions to remake the institutional deal. Since leaving the status quo makes the poorer regions worse off, the latter cannot credibly threaten to exit the federation if no changes are implemented. Hence, in this example, there is a clear pro-status quo bias.

⁵ Unions that have initial low levels of inequality will have to strive to maintain it over time – otherwise they risk jeopardizing their existence. To maintain low levels of inequality, the union’s policies will have to be relatively intrusive, i.e. they need to make sure that conditional growth rates are roughly equivalent across regions. Two things stand out from this: one, the looser a federation is, the more volatile growth rates will be (and, on average, the more innovation will happen); two, looser federation will be politically more stable (since they are not hurt by widening income distributions).

By contrast, in a scenario in which the incentives to maintain a strong state decline, wealthy regions will favor a more decentralized union. Poorer regions will not be in a position to block any changes since the wealthy can threaten with secession. Federations should become looser and the level of redistribution should decline as well.

These considerations have interesting empirical implications for Rodden's study and for future studies that look at the evolution of redistribution over time. First, demands to rewrite the territorial contract will always come from those regions that can credibly threaten to exit – this is normally the case for wealthier territories. Second, the resulting level of political instability will be different depending on the current degree of integration: loose unions will be much more stable than highly centralized unions.