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# Stability in Political Unions: Inequality, Borders, and Welfare

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## Abstract

Concerns about boundaries are concerns about *who does what* as much as they are about *who gets what*. To the extent that social policy is in itself a fundamental tool for the construction of a common national identity, as cogently argued by Banting (1985), understanding how and why unions react to crises sheds light on the mechanisms driving the stability of borders and political contracts. In this paper I argue that a key factor to understand why political unions in some cases face demands for secessionism (or pressures to preserve a decentralized status quo) while in others opt for political integration lies in the balance between economic heterogeneity and externalities among the members of the union. When economic heterogeneity dominates, a common social contract becomes unfeasible. When externalities across borders pool risks among otherwise heterogeneous units, actors coordinate their political response and integration emerges as a political option.

**Keywords:** Integration, Inequality, Borders, Redistribution, Unions.

# Stability in Political Unions: Inequality, Borders, and Welfare

## I. Motivation and puzzles: differential responses by political unions

In this paper I use a political-economy framework to understand the conditions under which economic crises lead to either fragmenting or integrating responses. I do so by focusing on the realm of fiscal and social policies, as they are highly salient tools in times of scarcity that quickly become the bone of contention among members of the union.

I define as a fragmenting response a situation in which either member states manage to preserve a decentralized status quo or a significant number of union members launch a challenge to modify the constitutional contract and gain substantially more political autonomy and control over resources. The most extreme fragmenting response is, of course, the pursuit of full political independence from the preexisting union. I define as an integrating response a situation in which units with constitutionally protected powers over major policy realms decide to change the constitutional contract to transfer those powers to a higher level of power. Such transformations would imply direct control by Brussels over taxes and transfers in the European Union or, as it happened in North America during the 1930s, a transfer of authority from the states or provinces to the federal government.

In the aftermath of the Great Recession triggered by Lehman Brothers' collapse, Europe and the world have witnessed an upsurge of conflicts over who does what within existing political unions. As resources become scarcer, different crises catalyse tensions that have always been there. As analysed in this working paper series (Díez Medrano 2017), two cases have risen to the front page of territorial tensions in recent times. The UK, after averting in referendum the Scottish National Party's will to break with the UK as a fully independent nation in the EU, chose also in referendum to break with the EU. Given the spatial distribution of the vote, the Scottish government and people, recognized as a sovereign demos in the earlier referendum, are currently demanding a second opportunity to break with London and remain under Brussel's umbrella. And the Irish question is reemerging with a somewhat unanticipated push as the possibility and nature of Brexit becomes clearer over time.

Further south, Catalonia has occupied a most prominent position in Spain's political agenda since the early 2000s. Support for independence has grown sharply due to the joint impulse of two factors: (1) the crisis has enhanced the implications and politicization of fiscal imbalances and (2) the institutional system designed in 1978 has exhausted all degrees of freedom to accommodate demands for a better institutional and fiscal arrangement moving forward. The Conservative government has remained committed to a restrictive interpretation of the original constitutional contract that has proven successful both as an electoral strategy in the rest of the union and as propeller of the pro-referendum, pro-independence movement. The conflict does not seem easily resolvable given the current stands on fiscal and identity issues by the main actors involved.

A cursory overview of these experiences suggests that economic crises unsettles existing equilibria within political unions. Tensions are as much about the flag as they are about the purse. They combine an economic and an identity component, often intertwined by political actors' discourses. Concerns about boundaries are concerns about *who does what* (identity) as much as they are about *who gets what* (distribution). Jointly, they determine preferences within the units and the strength of political movements.[1] To the extent that social policy is in itself a fundamental tool for the construction of a common national identity, as cogently argued by Banting (1985), understanding how and why unions react to crises sheds light on the mechanisms driving the stability of borders and political contracts.

In what follows, I do not assume that economic motivations are the only driver of a process in which actors feature multidimensional preference spaces. Rather, I reason from the premise that understanding these motivations helps understand why conflicts over boundaries and policies follow economic crises, and more importantly, why the observable political responses across unions vary. North American federations were hit similarly by a sequence of economic downturns that reached its peak during the late 1920s and early 1930s. These downturns brought about dramatic social consequences on both sides of the border. As a result of a number of structural transformations[2], both unions suffered precipitous declines in their income per capita (Achembaum 1986, 16-17; Struthers 1983, 44-104) and rapid increase in the unemployment rate.

[1] For example, supporters of an independent Catalonia would like to see an independent social security agency because this way they can decide how to organize their fiscal system and prevent an unduly transfer to territories they perceive as both alien and undeserving.

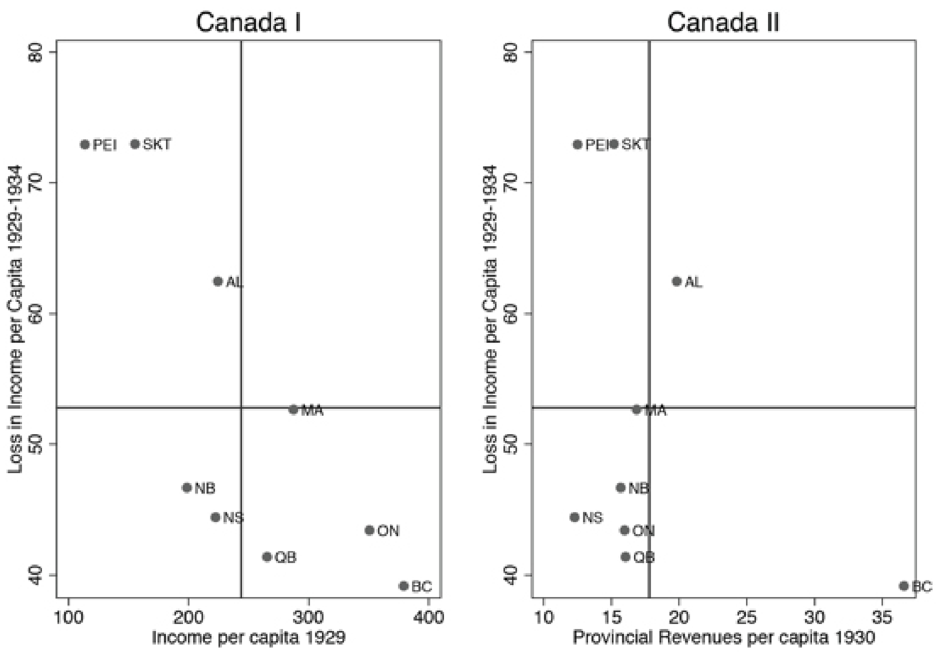
[2] Briefly mentioned, these were four: an ongoing process of de-ruralisation that created a massive surplus in the Canadian and American labor forces, the European monetary crisis (1930-31), an insufficient and late reaction in terms of macroeconomic policy, and finally and most visibly, the worldwide collapse of financial and stock markets. Together these four factors provoked a long-lasting reduction in both wealth and consumption, themselves affecting the expectations about recovery and thus making the Depression longer (Temin 1976, 62-96, 138-179).

The peak was reached around 1930-1931. In Canada, 19.32% of the civilian labour force was unemployed.[3]

A critical feature of the crisis was its uneven territorial incidence. After capturing the intensity of deprivation associated with the depression ("the livelihood for hundreds of thousands of citizens seemed to be entirely dependent upon public charity" (1940, 162)), the Royal Commission on Dominion-Provincial Relations paid careful attention to the spatial patterns of incidence of the socioeconomic implications of the sudden downturn.

By way of illustration, figure 1 maps the distribution of provinces along three variables: the level of regional income per capita at the beginning of the crisis (1929), the drop in personal income per capita between then and the Depression's peak (1934-35), and the level of financial capacity of subnational governments, as captured by the provincial revenues per capita in 1930.[4]

**Figure 1:** *Spatial patterns of the Great Depression in Canada*



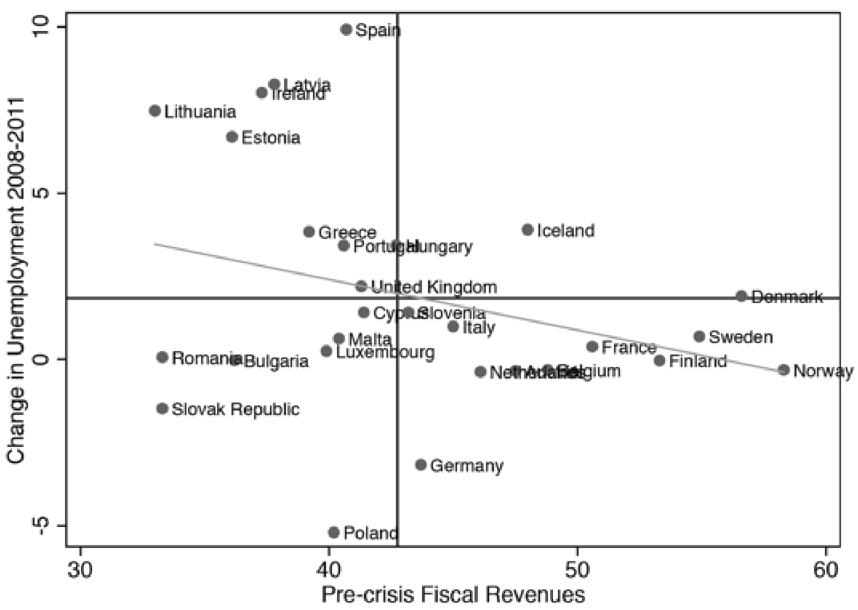

[3] D. Guest (1997, 83) offers estimates that put Canada closer to the USA, around 24%: "At the bottom of the Depression in 1933 nearly one quarter of the labor force was out of work and seeking jobs and an estimated 15 per cent of the population was in receipt of relief."

[4] Canada. Historical Statistics. Unemployment rate: the percentage of the total civilian labor force that is "not working and seeking for a job" USA: the unemployment rate is defined as one minus the proportion of the civilian labor force that is actually employed (Sources: Historical Statistics of the United States. Colonial Times to 1957, U.S. Department of Commerce, Bureau of the Census, 1961, pp 68-69).

Amidst a context of economic decay (after all, the "lucky" provinces saw drops of 30-40% in their levels of income per capita), it seems undeniable that the depression hit some regions much harder than others. Those provinces whose economies were of an agrarian basis were especially damaged by the fall in consumption and the attendant drop in agricultural prices.[5] In Canada these were the western, prairie provinces, Alberta and Saskatchewan most prominently. As figure 1 displays, these two provinces not only were among the poorest in terms of income per capita in 1929 but also took the worst hit, together with Prince Edward Island, by losing between 60 and 70 percent of their income five years into the Depression.[6]

Generally, it was the case that those with the worst problems had the least resources with which to respond. The situation was particularly extreme given the very low fiscal capacity for states and provinces: while the average provincial income per capita in Canada was around $240, the average provincial revenue per capita was $18. The right hand side of figure 1 also suggest that this scarcity was quasi-uniform throughout Canada, with the relative exception of British Columbia. Faced with such a worsening of social conditions, the existing welfare institutions were politically and financially powerless.

**Figure 2:** *Spatial patterns in the Great Recession*

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5 Guest (1997,83-135) reports, for instance, a fall in the price of wheat from $1.60 in 1929 to 38 cents in 1931.

6 Patterson (1986) and Alston and Ferrie (1999, 49-50) document very similar patterns for the United States.

Mutatis mutandis, the situation was similar in the EU after the collapse of Lehman Brothers. Figure 2 plots the relationship between the fiscal capacity of EU countries right before the crisis and the increase in unemployment during the first five years of the financial crisis.[7] As in the case in Canada, there are significant differences in the social incidence of the crisis among members of European Union and, in particular, among Eurozone members. Furthermore, patterns are also similar in one fundamental sense: those least equipped, in terms of resources, to deal with the social consequences of the crisis were hit harder. Spain, Ireland, Greece, and Portugal, to name just a few cases, feature both low levels of precrisis fiscal revenues and high increases in the unemployment rate between 2008 and 2011.

The two crises, the Great Depression in the 1930s and the Great Recession in the early 2000s, also share important political characteristics. In both instances, member states have (had) constitutional veto power to block any attempt to alter the boundaries of social policy provision. The transfer of social welfare policy control to Ottawa required a formal constitutional reform over which major provinces held veto power. Similarly, any attempt to further develop a European fiscal system with tax-and-transfer powers over its citizens requires the unanimous consent of all union members. And yet, despite the similarities in the patterns of incidence of the crisis, and in the institutional guarantees protecting member states, the responses were divergent. Canada pursued an integrating solution, whereas the EU remains committed to a fragmenting one.

Canada's Unemployment Insurance Act (1940) is the result of a political process that reverted the existing territorial design of welfare provision since the origins of the country. Its approval took a major constitutional amendment that spanned between 1936, a year in which the provisions regarding unemployment of the Bennett's New Deal (1935) were declared unconstitutional by the Supreme Court of Canada and the Privy Council of Great Britain, and 1940, a year in which the Federal Government and the provinces agreed to reform the British-North American Act so that the former could, among other things, take full control of the emerging national program of Unemployment Insurance. I should note that this reform upwards took place in a union with competing linguistic and political identities, much like Spain and in a larger scale the EU.

Europe's response remains rather different. The response reflects in part its own history. What originally emerged as a geopolitical agreement to prevent Germany's rearmament quickly evolved into an unintended federation of sorts, the EU, one in which the balance between widening and deepening, between national interests and supranational

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[7] Total tax revenues as a percentage of GDP (OECD Government Statistics); Unemployment Rate as defined by Eurostat.

institutions is a constant object of political contention (Scharpf 1985). This process has yielded a peculiar institutional form that is neither a federation nor a confederation, but rather a unique form of political union. This idiosyncratic institutional construct has built itself politically and economically in many ways by "failing forward" (Jones et al. 2016) under the auspices, and according to the interests, of its core members, most notably France and Germany (Moravscik 1998; Schimmerfenig 2015). Against this background, the financial crisis, and more recently, the refugee crisis both provide instances in which the union's internal tensions grew starker. In the former case, the reaction was mixed, with a combination of unwillingness to integrate fully along with various institutional reforms towards financial stabilization; in the latter case, the Union has engaged in a conflict about how to tackle the costs, economic and political, associated with the incoming flow.

What led Quebec and Ontario to transfer its constitutional authority over social policy to Ottawa while Catalonia persistently demands full control over taxes and transfers (social insurance) and the notion that Brussels can become an actual realm for fiscal policy remains either a utopian dream or a dystopian nightmare, depending on political taste?

The rest of the paper is organized as follows. Building on earlier theoretical work, I first lay out the reasons behind these differential responses. Second, I provide a comparative analysis of the responses of Canada to the Great Depression and the EU to the Great Recession as a way to substantiate empirically the analysis. Finally, I conclude by drawing some implications from the analysis for the current challenges in the European Union, most notably the refugee crisis and Brexit.

## II. The logic: responses to crises and political stability

To make sense of these choices, I argue, one must pay attention to two factors: the incentives or preferences of core actors, and the extent to which the institutional status quo at the onset of the crisis allows them to transform these preferences into policy.[8]

[8] A premise underlying the analysis is that all political unions have multiple politically mobilized identities. This is certainly the case of the EU, the UK, Spain, Canada, and to a lesser extent, the US with its embedded politics of race between North and South. The focus here is on the role of politico-economic factors in the presence of these multiple identities.

## Preferences

As developed in Beramendi (2012), actor's preferences for an integrating or a fragmenting response depend on two variables: the degree of economic heterogeneity across the regions and the scope of economic externalities across regions. Economic heterogeneity polarizes preferences among member states as it exacerbates differences with respect to: i) how much to tax individuals within units; ii) how much of each state's tax base is to be shared with other states; and iii) whether a common economic policy is suitable for different economic structures and labour markets.[9] As units differ in their economic structure, the size of the tax base, and the incidence of inequality, the feasibility of a common policy regime that cuts across boundaries declines. The main reason is that the distributions of resources and risks (Rehm 2016) correlate very highly, thus polarizing views among key political actors. These differences are captured in the horizontal axis of Figure 3.

In turn, the presence or absence of externalities moderates the impact of inequality and risk polarization in the process of preference formation. In the absence of externalities, economic heterogeneity plays a dominant role as a determinant of preferences, pushing towards either secessionism (under centralisation) or the preservation of fragmentation. In the presence of externalities, the political logic changes significantly (Rueda and Stegmueller 2015).

Economic externalities depend primarily on the extent to which factors, labour and capital, travel across borders and their implications for country's risk profiles (Cai and Treisman 2005). Labour flows work as a transmission mechanism of labour markets and social insurance risks between territories.[10] At a different level, capital cross-border linkages within a common economic and monetary area facilitate the exposure, as a result of the pattern of internal lending and borrowing (Hale and Obstfeld 2014), to financial risks.

Consider the case of large levels of mobility among the unemployed. In such case, the region expelling unemployed poor people increases its employment rate and average output, whereas the recipient region sees both magnitudes drop. As a result, both regions also come closer in terms of the nature of the distributive conflict among their

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[9] For additional theoretical and empirical work on these mechanisms, see Bolton and Roland (1997), Alesina and Spolaore (2005), Perotti (2001), Beramendi (2007), Sambanis and Milanovic (2014).

[10] By labour flows, I refer to mobility of workers and potential dependents across borders. For other analyses where increasing labour mobility facilitates the adoption of common social policies, see Bolton and Roland (1996) and Perotti (2001).

citizens. More importantly, as the poor travel across regional boundaries, net welfare recipients in wealthier regions lose their ability to protect their tax base by keeping a decentralized insurance system and reducing interregional redistribution.[11] Regarding capital and debt flows, a similar process unfolds. If the geography of debt is such that wealthier areas are exposed to negative shock via the risk of poorer areas actually defaulting in their payments, then the risks associated with economic collapse are no longer concentrated territorially.

By acting as a multiplier of social shocks across territories, labour and capital or debt flows thus become a new source of risks for which wealthier members of the union have incentives to create some form of insurance. If risks travel across boundaries, the incentives to pool resources and design common solutions grow. As a result, political systems where large scale externalities compensate the polarizing impact of economic heterogeneity will take steps towards political and economic integration in response to crises.

### Institutional status quo

Actors' ability to transform their preferences into policy largely reflects the status quo at the time distributive tensions grow salient: figure 3 below distinguishes between a centralised and a fragmented status quo. In the first case, the strategic interaction between key actors begins with the centre holding policy control across member states' boundaries. As a result, the veto lies with the overall demos of the union as a whole. In the second case, member of the union control policy at the onset of the crisis and each individual demos must decide whether to delegate political authority to a realm above member states. Both Canada and the EU fall into the latter category, whereas Spain would constitute an example of the former.

Figure 3 summarizes the main predictions given different combinations of status quo institutional arrangements, internal economic heterogeneity, and scope of externalities. The left side of figure 3 considers first a status quo of centralisation (such as Spain from 1978 onwards). The right side of figure 3 considers a status quo of fragmentation (such as North American federations in the 1920s or the European Union today). Within each side, the horizontal axis represents variation in the incidence of economic heterogeneity. The vertical axis represents variation in the scope of externalities, as defined above.

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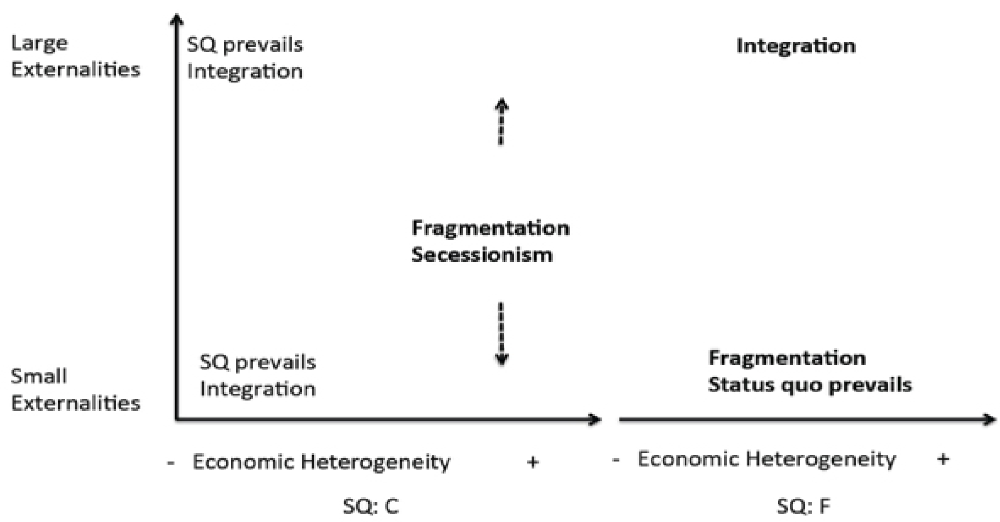
[11] Interregional mobility of dependents from depressed to prosperous areas implies by definition an interregional transfer of resources between regions in the union.

Consider first a case in which the status quo is centralised and there is little inequality across territories. At the extreme this is a hypothetical scenario, as there are no democratic polities without some degree of economic heterogeneity within their territories, in which I expect the status quo to prevail. In the absence of inequality, there are no political tensions between units. As a result economic externalities across them bear little consequence on the ultimate outcome.

A more interesting case is one in which preexisting inequalities decline in a context of decentralisation. The decline of inequalities across units may reflect very different causes, and it often comes accompanied by the presence of significant cross-unit externalities that operate as a mechanisms transmitting exposure to social risks across boundaries. Under such circumstances, I expect an institutional change towards integration. By contrast, in the presence of persistent (or increasing) economic heterogeneity, or in the absence of large scale economic externalities, I would expect a preservation of a decentralised status quo.

Finally, figure 3 also speaks to scenarios in which inequalities increase given a status quo of centralisation. In such a case, I expect tensions over scarce resources to escalate and give birth to a political movement in favour of increasing political fragmentation. At the extreme, this movement takes the form of a pro-independence platform.

**Figure 3:** *Summary of the argument*



I do not have enough space to compare systematically the predictions across all different scenarios. Instead, in the rest of the paper I compare two experiences that speak to the theoretical mechanisms outlined in this section: the decision by Canadian provinces to pass a constitutional reform that essentially integrated the bulk of social policy at the federal level, and the opposition by European electorates to further integrate fiscal policy in the aftermath of the financial crisis. The former illustrates the role of externalities; the latter, the role of economic heterogeneity.

## III. A brief recapitulation of the Canadian experience: war and migration as externalities overcome distributive tensions

The Great Depression put unemployment at the centre of the political agenda, conditioning both the competition between the Liberals (1921-1930; 1935-1941) and the Conservatives (1930-1935) and the dynamics of the Dominion-Provincial relations. Until the Depression, the unemployed were so because of "some fault of their own" and hence society should apply the criteria of "less elegibility," which implies caring just for those obviously unable to fend for themselves (e.g., war injured). As economic conditions worsened, both the demands by provinces and municipalities and the stringency of public finances grew stronger. Much of the contention was about passing the buck. Provinces and municipalities were overloaded. At the same time, Ottawa kept its financial and administrative involvement to a minimum, pointing to the fact that, constitutionally, taking care of the unemployed was outside its jurisdiction. Until the 1930s, unemployment was not considered a collective social problem that required federal intervention. By 1940, the roles were exchanged: unemployment insurance was designed as a fully federal program, national in scope.

It was precisely the role of externalities what transformed the social and political perceptions of unemployment and led to an institutional response that transcended preexisting boundaries (Guest 1997, Pal 1988, and Struthers 1983). This process took place in three major stages, defined by the parties occupying the federal office:

a. *Liberal–progressive response: back to the land and creation of a massive pool of seasonal agricultural workers [1921-1930]*

   Liberal Progressives depended on farmers as a core constituency and tailored policy responses to their interests. During the post-World War I years, farmers were short of labour force. The Progressive Party led the government to pursue a two-fold policy on the issue, namely to relocate the unemployed to work in farms ("back to the land" strategy) and to facilitate the immigration of unskilled workers to help either with farming or the extraction of natural resources. Such strategies created a huge group of seasonal, highly mobile, workers (transients). Depending upon the time of the year, they would be hired in different provinces across the country to perform high effort low skill tasks.

b. *Conservative response: provincial "self-reliance," public order, and sudden flip [1930-1935]*

Bennett took office at the peak of Depression (1930-32), with provincial and local governments overburdened by relief demands, and increasing political momentum in favour of unemployment insurance, a policy supported by municipalities, the unemployed, organized labour as well as an important share of Canadian businessmen. The transients issue was growing in importance: according to Whitton's estimates (1933), there were up to 100,000 seasonal workers in the west on whom unemployment was (and would continue to be) especially concentrated. Because of the seasonal nature of the employment relationship, these migrant workers operated as a risk homogenizer across subnational units. Accordingly, municipalities and provinces looked at Ottawa and demanded a response to the added relief burden of the transients. Bennett insisted on approaching the issue as a relief problem and adopted a strict policy of "provincial self-reliance" in what concerned Dominion-Provincial financial relations, constraining the provinces' capacity to take debt to $1M a year. In addition, he complemented his policy conservatism with the launching of National Defence Relief Camps, a system of concentration camps for "single unskilled men and recent immigrants" in which they would work for the government in exchange for the meals, shelter, and money received as relief.[12]

These measures proved insufficient. The proximity of the elections led Bennett to present his own New Deal in a series of radio speeches to the nation outlining a number of initiatives, including a national minimum wage, working-hours legislation, a more progressive tax system and, among others, a contributory old-pensions, health and unemployment insurance. The Liberals highlighted that most of these initiatives would require a reallocation of political capacities from the Provinces to Ottawa but did not oppose the Employment and Social Insurance Act, passed in March 1935.[13] Bennett's proposal was never implemented.

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[12] The explicit goal of this latter initiative was to expel the specter of socialism by drawing transients out of the cities.

[13] Inspired by the 1911 British System, the proposal for unemployment insurance had stricter benefits, in accordance to the less eligibility doctrine, and very limited coverage (the primary sector was excluded, dealt with only through relief). Moreover, the government would only cover 1/5 of the total cost of the program and neither sickness nor transitional benefits were considered. In general, federal involvement would remain to a minimum in that the Unemployment Insurance would be neither financed nor administered by the Dominion.

The Supreme Court (1936) and the Privy Council in London (1937) declared it ultra- vires, restating the need to amend the BNA if Ottawa was to develop any unemployment insurance program.

c. *Liberals' return to power and Constitutional reform [1935-1941]*

At the same time, the transients regained salience as a political issue: strikes in BC camps, the Regina riots, and the On to Ottawa Trek marked an upsurge in social unrest at the same time the financial relations between the provinces and the Dominion collapsed. Unsurprisingly, Mackenzie King and the Liberals regained office (Struthers 1983, 137). King appointed a National Employment Commission (NEC) which recommended the closure of the relief concentration camps and their substitution for a land settlement program (1936). In addition, after Bennett's constitutional fiasco, King also sounded the provinces regarding the amendment of the Constitution. To this end he appointed in August 1937 the Rowell-Siros Commission on Dominion-Provincial financial relations.

This reform would imply a major overhaul of political authority within the Canadian federation. As the process begun, the initial distribution of preferences was as follows. Six provinces, including British Columbia, agreed to transfer the capacity to deal with unemployment to the federal government. New Brunswick decided to wait for the conclusions of the Commission before making a decision. Quebec and Ontario, provinces with average to high income per capita and relatively less hit by the Depression (figure 1), wary of the fiscal and political implications of a common program, claimed concerns about provincial autonomy and refused the amendment. Finally, Alberta's premier (Aberhart), whose earlier attempt to develop a system of Social Credit specifically tailored to the type of production dominant in the province had been overruled by Ottawa, rejected any constitutional amendment unless he could see the specific legislation first. At this point, as a unanimous agreement on constitutional reform was not within reach, largely because of reasons directly linked to the economic heterogeneity among the provinces.

Interestingly, the initial distribution of preferences changed for two reasons. First, and foremost, high levels of mobility among dependents lit again tensions between Ottawa and the provinces, in particular BC, whose capital, Vancouver, was a natural point of destination for transients.[14] The fiscal and financial strains associated with the transients

[14] Estimates by the municipal relief office indicate that during 1930 Vancouver's population increased by five percent due to the arrival of 10,000 seasonal unemployed begging for care.

did not sit well with Ottawa's balanced budget approach to fiscal federalism. The issue quickly involved other provinces.[15] Transients had become, again, the most visible symbol of the shared, non-local, nature of the unemployment problem.

Second, the beginning of World War II added a second source of cross-regional externalities, ultimately pushing the Government to seek the constitutional reform even before the publication of the Rowell Siros report. The concerns about the future demobilization and the socioeconomic integration of veterans, already salient after World War I, rendered unemployment even more national a problem. Taken together, all these factors gradually erased the hesitations among the provinces that either doubted or openly opposed the amendment, particularly those that, because of identity reasons, were especially jealous of their policy autonomy such as Quebec or Alberta.[16]

In July 1940, following the recommendation of the Rowell-Siros report, the Unemployment Insurance Act was approved. The report also suggested a centralization of taxation and the design of an interprovincial system of revenue sharing so that the average provincial cost of relief would end up being equalized.

## IV. The EU experience: economic heterogeneity with partial externalities

Events have unfolded rather differently in the EU in the aftermath of the Great Recession. Contrary to the Canadian experience, where political integration occurs, the EU is a case where the fragmented political status quo has survived the crisis and is likely to persist. Despite the well established theoretical notion that all successful monetary unions have eventually been associated with a political and fiscal union (Popitz 1927; Dixit 1996; Perotti 1996; Drazen 2000; Casella 2005), the European Union failed to realise the efficiency and insurance gains associated with fiscal integration before the crisis. And there hardly is political momentum in support of a shift towards fiscal integration (Hall 2012; Krugman 2012). The reason I put forward in this paper is that

[15] In response, the BC premier successfully forced Ottawa to pay for the relief expenditures generated by non-resident workers as a result of the closure of camps.

[16] As analyzed earlier (Beramendi 2012, Struthers 1983), unemployment itself contributed to the replacement of M. Duplessis, Quebec's conservative premier, by A. Godbout, a Liberal who quickly switched positions. In turn, the level of economic externalities and the War undermined Ontario's earlier concerns for its fiscal position within the union. Finally, Alberta's premier, faced strong pressures as he became the only opponent, on the basis of Alberta's specific regional economy, to an amendment viewed as a national need for the difficult days ahead.

no comparable cross-unit externalities were at work at the same time that, as shown in figure 2 above, the economic heterogeneity among the members of the union grew as a result of the crisis.

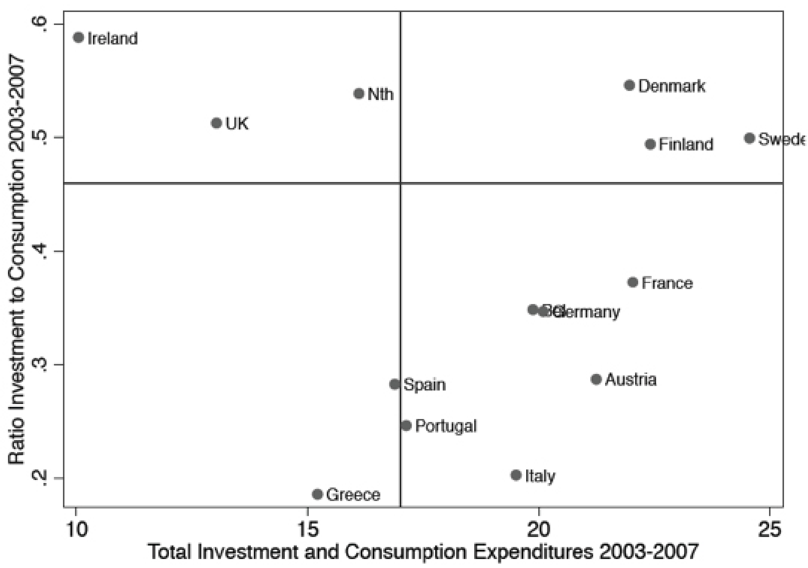
There is no gainsaying that European labour markets feature very different economic strategies. Elsewhere (Beramendi et al. 2015), we have distinguished between consumption- and investment-oriented growth strategies as defining features of European political economies. I define "investment" widely as the use of public expenditures that increase the overall productivity of the economy, and that of labour and capital in particular.[17] The term investment refers to the future-orientation of these expenditures in the fields of education, research and development, childcare, and labour market activation (Acemoglu et al. 2006; Aghion and Hewitt's 2006). On the other hand, I consider "consumptive expenditures" social transfers to beneficiaries that use them in order to cover current needs and demands. Governments' choices reflect how much they privilege consumptive expenditure at the expense of future returns via investments in education, research and development, and child-care. The balance between these two sets of policy instruments is critical to understand the political economy of growth and inequality in the postindustrial world: investment-oriented economies by and large perform better and generate more egalitarian outcomes than consumption-oriented ones. In addition, a critical difference for the argument in this paper lies in their trade orientation within a common currency: investment-oriented economies tend to privilege export-driven growth strategies, whereas consumption-oriented ones rely more heavily on import-oriented economic policies.

The EU harbours distinctive groups of investment- and consumption-oriented economies, as captured in figure 4[18], where I present in the x-axis the total sum of expenditures in both consumption and investment and in the y-axis the ration of investment expenditures to the sum of consumption and investment expenditures.

[17] A slightly narrower distinction between consumption- and investment-oriented expenditures has also developed in the welfare state literature (e.g., Esping-Andersen 1999).

[18] Consumption and investment expenditures in EU member states. For definitions and sources, see Beramendi et al. (2015).

**Figure 4:** *EU economic strategies at the onset of the crisis*




There are major differences in the way EU members managed their policy priorities before the crisis. High skill, competition-oriented labour markets feature large social and investment budgets (Denmark); the UK and Ireland clearly prioritize investment at the expense of consumption; France and Germany put effort on both categories yet consumption seems relatively more of a priority. Finally, Spain, Portugal, and Greece (and to some extent also Italy) spend much less in total with a clear bias towards consumption. Because of the split between consumption- and investment-oriented economies, European job markets were fairly isolated before the crisis, except for a very small share of the high skilled labour force. To the extent that labour markets continue to be specialized due to the divergence in economic strategies among EU members, unskilled workers from the periphery have little future in northern specialized economies. As a result, labour flows remain limited to the upper ranks of the skill distribution and are unlikely to constitute a major source of economic externalities. Figure 5 plots the correlation between the mobility rates in Europe in 2007 and 2011.[19] Figures represent for each country and year the share of population coming from other EU countries relative to the national population. Clearly, not much has changed as a consequence of the Great Recession. The scope of mobility patterns suggests no process capable of homogenizing either risks or fiscal bases across EU nations.[20]

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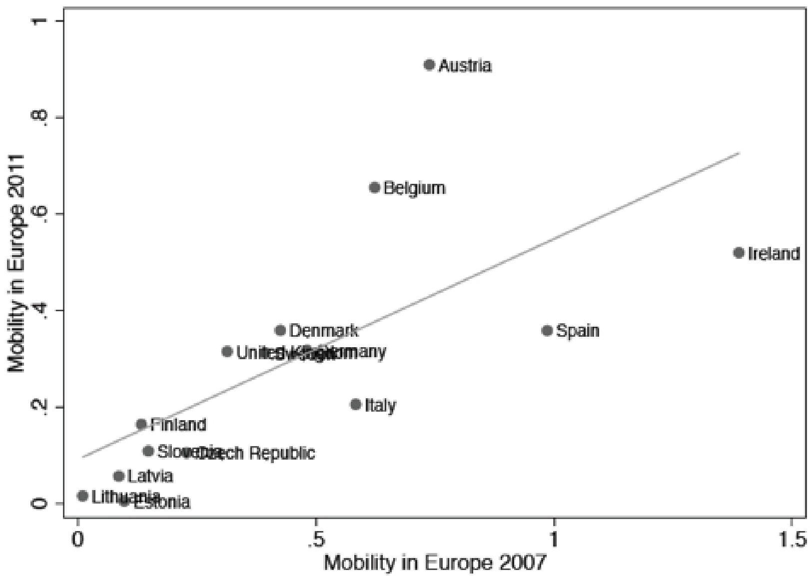
[19] Author's calculations on data from Eurostat.

[20] In Beramendi and Stegmueller (2006) we study the origins and implications of a much more important source of risk across borders, namely the exposure of banks in core countries to the possibility of default by heavily indebted economies.

**Figure 5:** *Limited mobility in Europe 2007-2011*




A heterogeneous economic geography translates, quite directly, into divergent patterns of inequality. Figure 6 plots the relationship between the share of investment to total expenditure and the degree of inequality across EU members as measured by the p90/p10 (the ratio between the top and the bottom deciles) in disposable (post-tax and transfers) income.[21] Investment-oriented economies with larger states are the ones with the lowest degree of inequality (and vice versa). This in turn suggests that the risk pools (Rehm 2016) within EU nations are significantly different from each other. According to the argument laid out in figure 3, it is politically much harder to envision political reforms towards integration. The balance between externalities and economic heterogeneity is clearly tilted in favour of the latter. The relationship between economic strategies and the incidence of inequality in Europe and its implications for political preferences is actually quite stable over time between 1980 and 2000 (Beramendi et al. 2015) and only grows stronger in the aftermath of the financial crisis.

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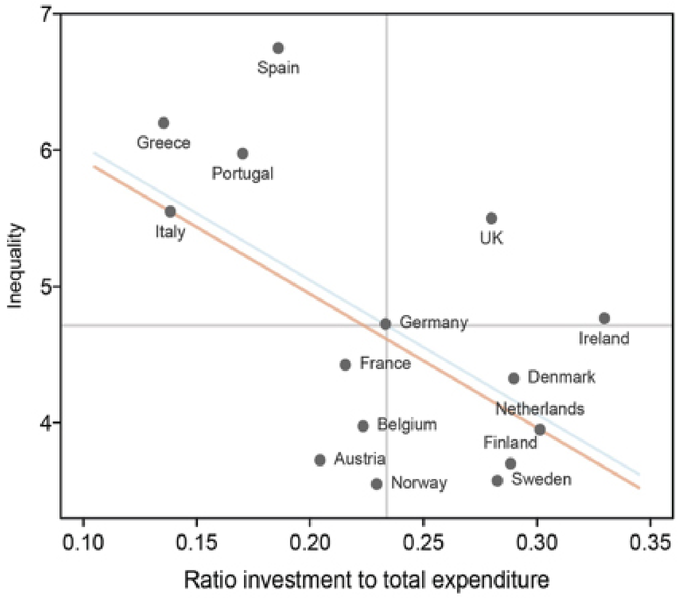
[21] Inequality Data: Gini Coefficient for Disposable Income Inequality as reported in Eurostat. Ratio of Investment to Consumption and Investment expenditures in EU member states. For definitions and sources, see Beramendi et al. (2015).

**Figure 6:** *Economic heterogeneity in the European Union*



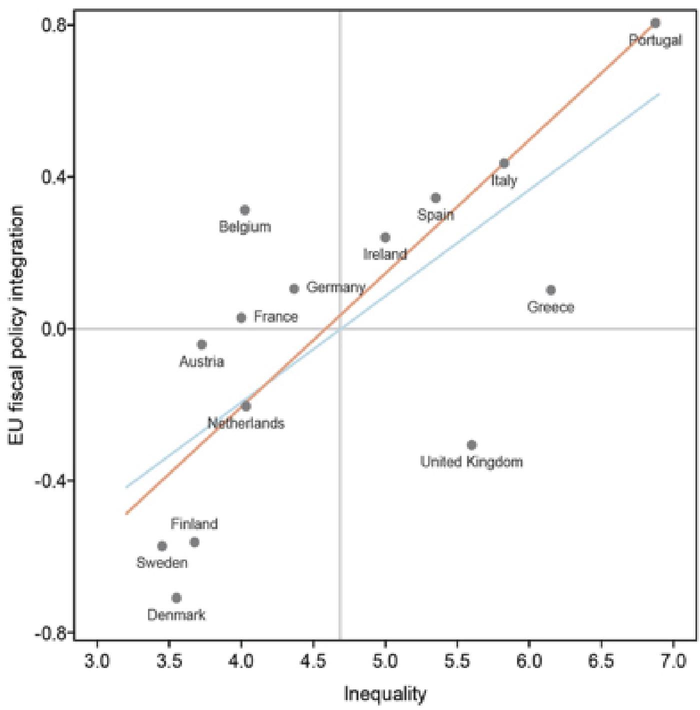

To be sure, several proposals for advancing fiscal federalism in the EU have been advanced (Pisani-Ferry et al. 2013; De Grauwe 2014). These proposals vary in ambition, design, and redistributive impact, but they tend to share similar political fates. A common European budget would imply a standard system of automatic stabilizers and massive redistributive transfers across the territories of the union. A second, slightly more realistic, approach would involve the mutualisation of default risks through the so-called Eurobonds, an idea Macron seems to be intent on putting back on the agenda. Again, an actual default would imply, under such a system, a significant transfer of resources between members of the union. Finally, from a nuanced understanding of the specific constraints at work in the EU crisis, the Tommaso Padoa-Schioppa group proposed an automatic cyclical adjustment insurance fund to make palatable internal devaluations through inter-temporal, countercyclical management (Enderlein et al. 2012): the idea is to accumulate buffers in good times and use them automatically in bad times. In addition, a European Debt Agency will manage according to clear criteria and strict procedures the trade-off between accessing bailouts and the preservation of budgetary sovereignty. Again, the adoption of such a system would imply a major step up in the level of fiscal federalism and redistribution between the EU members.

So far, very little has happened in the direction of creating a common budget, let alone a common welfare state.[22] The main reason, I contend, lies in the political configurations within European democracies.

[22] Interestingly, much more has happened in the development of targeted mechanisms of financial stabilization. Beramendi and Stegmueller (2016) show how the support for bailouts increases in exposure to financial risks associated with the potential default of south European economies.

Going back to Moravcsik's (1998) notion that integration reflects both the preferences of key players in the union and the relative balance of power among them, it is easy to identify the mechanism constraining further efforts towards integration. EU governments' positions on the subject are constrained by their citizen's views. The latter, in turn, are largely shaped by the scope of economic heterogeneity within the union. Figure 7 plots the relationship between inequality and average support for tax integration in the EU after the Great Recession.[23] Clearly, the higher the inequality, and the lower the resources, the stronger the relative support for a policy proposal to partially delegate national fiscal policy to Brussels.

**Figure 7:** *Inequality and support for integration in post-crisis Europe*

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[23] Figure 6 plots the relationship between inequality and country-level intercepts obtained from a Bayesian multilevel model nesting inequality data for 14 European countries (Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Netherlands, Norway, Portugal, Spain, Sweden, and the United Kingdom) to individual level attributes and attitudes. For more technical details on the approach, see Beramendi and Stegmueller (2016). Sources: (Eurobarometer 74.2, fielded in the Fall of 2010, n=13400). The exact wording of the dependent variable is as follows: "For each of the following areas, do you think that decisions should be made by the *(nationality)* Government, or made jointly within the European Union? 1 *(National)* Government, 2 Jointly within the EU". The individual level controls included in the analysis from the same dataset are: gender, age, labor market status (employed, unemployed, retiree), number of years of education, as well as their subjective perception of income.

This distribution of preferences translates into an outcome that reflects an asymmetric balance of power. The fiscally more resourceful core of central and northern Europe has managed to shape institutional reforms in the EU according to their interests from a very early stage, and the response to the Great Recession is no exception.

As Schimmelfennig notes, "asymmetrical interdependence resulted in a burden-sharing and institutional design that reflected German preferences and its allies predominantly" (2015, 179). The ultimate outcome continues to be a differentiated integration, heavily constrained by the stark degree of economic and identity heterogeneity among its members. In his contribution to this working paper series, Schimmelfennig argues how differentiated integration is a particular institutional solution to the trade-off between removing internal boundaries while at the same time protecting political autonomy. Differentiated integration protects individual members and minorities and by virtue of doing so allows, paradoxically, integration to proceed. The cost is first a slow pace, driven in large part by the mechanism highlighted in this paper: distributive tensions shape voters' preferences, which in turn constraint executives' bargaining and limit the scope of the feasible responses to crises; and second, a conspicuous inability to deal with crises that cut across national boundaries.

The argument in this paper speaks to these crises as well: either the scope of externalities to force a major institutional overhaul in the direction of integration or, when externalities are less far reaching in scope, the crisis triggers distributive conflicts about cost allocation and inefficient outcomes while the status quo prevails. The most recent refugee crisis provides an illustration of this dynamic.

In the long run, security issues have the potential to be the source of externalities across member states that re-bolster integration. If the mobility of potential risks homogenizes exposure across members, political support for common agencies or responses will lead to stronger federal efforts. To the extent that a common social policy is seen as a security response, safety concerns associated with large population inflows can be a path to overcome the resistance to integration identified in this paper. So far, though, the scope of the refugees circulation within Europe has not been similar to that on the transients, in large part because EU members are pursuing a range of alternative strategies (camps in neighbouring countries such as Turkey, or bureaucratic delays in the implementation of agreements about the allocation of refugees), solutions closer in spirit, not necessarily in design, to the work-camps initially designed under Bennett in the early 1930s.

## Conclusion

In their opening paper, the editors revisit the tension between functional, identity, and territorial drivers of borders and point to the fact that what is functionally optimal is not always politically feasible. The politics of re-scaling is one in which political incentives and functional needs interact most clearly. Crises and integrated markets, functionally, would be better handled through coordinated responses and institutional responses, yet such responses are only feasible under specific political conditions. In this paper, I have focused on the politico-economic determinants underpinning these differential responses.

I have argued that a key factor to understand why political unions in some cases face demands for secessionism (or pressures to preserve a decentralized status quo) while in others opt for political integration lies in the balance between economic heterogeneity and externalities among the members of the union. When economic heterogeneity dominates, a common social contract becomes unfeasible. To the extent that the welfare state is in itself an engine that forges a common national identity (Banting 1985), borders will be hard to overcome.

Differentiated integration poses an intermediate solution, one aimed at the preservation of borders, autonomy, and sovereignty while at the same time addressing functional needs in those areas where cross-border interactions become pervasive. Is this a stable, self-enforcing solution for the long run? Arguably, to the extent that it could be flexibly adjusted over time, it could well be the optimal design under the circumstances. But there are reasons to be sceptical about its stability. First, differentiated integration may have its institutional limits once the areas on which it is applicable have been exhausted. The dynamics of the Spanish *Estado de las Autonomías* and its inability to accommodate additional policy transfers illustrates this potential problem. The second reason concerns economic spill overs, which as neofunctionalist accounts of integration have indicated, would put pressure to extend coordinated solutions on areas where the intensity of preferences against it might be stronger. Finally, the third reason concerns the political push-back against such attempts: Díaz-Medrano (this working paper series) sees Brexit in part as an instance of uneven market integration, a process where distributional considerations are played up politically to challenge the institutional status quo. This paper shows how these distributional considerations link back to inequality and shape political preferences directly, thus nurturing potential institutional instability. Extreme inequality may reduce the scope of stable differentiated solutions.

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