

Costa-i-Font, Joan

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## Unveiling Vertical State Downscaling: Identity and/or the Economy?

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THE LONDON SCHOOL  
OF ECONOMICS AND  
POLITICAL SCIENCE ■



LSE 'Europe in Question' Discussion Paper Series

# Unveiling Vertical State Downscaling: Identity and/or the Economy?

Joan Costa-i-Font



LEQS Paper No. 20/2010

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# Unveiling Vertical State Downscaling: Identity and/or the Economy?

Joan Costa-i-Font\*

## Abstract

State rescaling may take a variety of shapes although scant research has been carried out into the mechanisms and economic incentives that underpin rescaling processes. This paper identifies and measures the effect of two broad state downscaling mechanisms, namely the development of regional identity - operating at the cultural level and proxing preference heterogeneity-, and the heterogeneity in levels of economic development; influencing the extent of regional redistribution. Firstly, we empirically examine our claim at an aggregate level using evidence from Catalonia and the Basque Country, to examine the evolution of sub-state identity and the rise of inter-territorial fiscal grievances - weakening intraregional economic solidarity. Secondly, we estimate how the combination of widening sub-national identity and regional redistribution strengthens support for vertical state downscaling. Findings suggest an expansion of spatial identities in both Catalonia and the Basque Country since the early 1980's. Ending regional fiscal solidarity it is found to increase the average income of Catalonia and the Basque Country by 37% and 17% respectively. Although we find evidence of elite driven support for state downscaling, the effect of regional identity on downscaling support exceeds that of regional redistribution in the magnitude of one to seven.

**Keywords:** vertical state downscaling, spatial identity, regional elites, devolution, Basque Country and Catalonia, Europe

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\* **London School of Economics and Political Science**

European Institute & Department of Social Policy, Houghton St, London WC2A 2AE, UK  
Email: j.costa-font@lse.ac.uk

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# Unveiling Vertical State Downscaling: Identity and/or the Economy?

## 1. Introduction

The current trend towards globalisation is argued to strengthen the roles of supranational and regional polities' vis-à-vis traditional nation state institutions (Omhae, 1995; Brenner, 1999 MacLeod and Goodwin 1999, Jessop, 2002, Jones, 2001; Marks *et al.*, 1996). This trend refers to the European move towards an unprecedented "regionalist project" involving a redefinition of identifiable social (e.g., language, culture) and institutional (e.g., the legal system, welfare policy, etc) scales, which is institutionalised in processes of decentralisation, federalisation and devolution.

In Europe, the formation of the European Union arguably qualifies as a bottom-up process of vertical state upscaling that coexists with the vertical downscaling of some government functions to sub-state entities. Vertical state downscaling processes are especially prevalent in all old European nation states. Not surprisingly, processes of regional devolution -or political decentralisation- are underway in most European large countries<sup>1</sup>. However, limited evidence is gathered on the determinants of downscaling pressures, and more generally on the latent demand for further devolution of authority underpinning vertical state downscaling. This paper sets out to argue that vertical state downscaling takes place through the mechanizing of social identities and its underlying determinants, namely cultural policies, which are

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<sup>1</sup> Evidence from the formation of Europe suggests that the process of vertical up-scaling takes place in waves of supranational competencies (e.g., the treaties of Maastricht, Amsterdam and Lisbon, all limiting the power of nation states). Similarly, as we empirically show in this paper, processes of vertical downscaling also come in waves of constitutional reform (see Keating 2009).

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in some countries traditionally the areas of responsibility devolved to region states. Simultaneously, downscaling results form incresing awareness of regional redistribution, which the economic literature identifies as motivating support for state downscaling in the form of opting out (Buchanan and Faith, 1987).

To date, the interdisciplinary political economy literature does not provide a comprehensive account of the underpinning state rescaling mechanisms. Economists implicitly refer to identity, when describing the existence of spatially defined clubs (Casella and Frey, 1992), which operate within current nation states and supranational institutions. Likewise, economic sociologists argue that socio-spatial scales evolve relationally within tangled vertical hierarchies (Brenner 1997), and are highly sensitive to changes in the sources of authority and economic performance (Smith 1995). More specifically, the question we inquire here is the following: what new relationships does devolution engender with regards to sub-state identity that in turn can explain further vertical state rescaling? To date both theory and evidence is scarce.

Fiscal federalism theory contends that rescaling in the form of fiscal and political decentralisation provides an institutional platform for a so-called 'preference-matching argument' (Oates, 1972). That is, a higher preference satisfaction (resulting form a better preference matching) will improve allocative efficiency<sup>2</sup>. Politically, though, devolution encompasses de dispersion of power among levels of government and it's driven accordingly to promote specific regional preferences, rather than purely national interests. Hence, the experience of decentralization may endorse both efficiency and power arguments. But how does rescaling take place? More generally, how does downscaling take place when institutional and social scales fail to match (Hooghe & Marks, 2003)?

This paper examines both the separate and combined influence of two parallel mechanisms that, are argued to underpin the process of vertical state downscaling.

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<sup>2</sup> For instance, education policy, a typically decentralized area of responsibility, is envisaged as a regional public good in heterogeneous states; and recent European survey evidence suggests that, unlike other areas of competence most Europeans prefer education policy to be managed by region states (Eurobarometer 57.1).

More specifically, it examines the influence of (elite) opposition to regional redistribution and the blossoming of regional identity (influencing cultural embeddedness) on support for state downscaling. Although conceptually different, these two mechanisms may reinforce each other. I draw upon the example of Spain to scrutinize the evolution of regional identity after devolution, along with the economic incentives in two distinctive region states within Spain, legally autonomous communities, that take the lead in the process of vertical rescaling, namely Catalonia and the Basque Country.

Although European nation states are a long way from completely vanishing, national economic governance progressively becomes more driven by regional coordination and competition (Costa-Font and Rico, 2006) and less by hierarchy and control, and this is especially the case in larger, commercially more open and socially distinct regions, which have developed strong regional elites. Evidence from Catalonia and to an extent the Basque Country suggests that territorial fiscal transfers from one region to another trigger regional collective action, which might call for the reallocation of regional income through pressures to reform regional financing and further downscaling calls. Given that fiscal redistribution may motivate the action of elites but not necessarily a wider societal reaction one should explore an additional mechanism that influences ordinary people's lives, namely the strengthening of regional identity and distinctiveness typically by instrumentalising objective elements such as language and culture in the case of Catalonia and the Basque Country.

This paper attempts to contribute to the literature as follows. First, it specifically identifies the role of economic and social incentives in motivating support for vertical state downscaling both in the form of regional redistribution and/or through strengthening spatial identities which capture the extent of cultural embeddedness in a society. The two mechanisms (identity and the economy) have not been examined before together, whilst the role of fiscal redistribution is generally the main variable the economics literature pinpoints in explaining secession (Buchanan and Faith 1987, Alesina et al, 2000, 2002), it typically disregarded identity as a channel for state



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rescaling. Second, drawing on the empirical case study of Spain, and particularly the case studies of Catalonia and the Basque Country, we inquire about the effect of changes in the fiscal redistributive position along with subnational identity in motivating support for vertical downscaling. It is argued that vertical downscaling results from both the strengthening of regional identity and the unwillingness (mainly by strong regional elites<sup>3</sup>) to redistribute fiscal resources at a state scale.

The empirical strategy of the paper has been to first identify the evolution of fiscal redistribution, by measuring the so called “fiscal residuum” - namely the effect on regional income of clearing regional redistribution- and spatial identity patterns. Secondly, the paper examines how these two mechanisms explain people support for a further downscaling of the Spanish state.

Our findings suggest that in Catalonia, the existence of competitive political bargaining with the central state to avoid the widening of the fiscal burden sharing (to levels of 8-10%) correlates with an increasing support for further state downscaling. The rationale of a simple multiplier model suggest that if regional redistribution ceased in Spain, regional income of the two region states examines would increase, particularly in Catalonia it is predicted to rise by 37%, and in the Basque Country, even though its privileged fiscal arrangement with the Spanish state, regional income is estimated to increase by 17%. Furthermore, we find that an increase of one standard deviation in regional identity *vis à vis* state-wide identity results in an effect on support for vertical state downscaling equivalent that seven times a similar change in regional redistribution.

The structure of the paper is as follows. Section two presents the conceptual background on the mechanisms for state rescaling and its economic incentives. Section three provides a brief description of the two cases studies examined, Catalonia and the Basque Country. Section four presents the political process, the evolution of support for state downscaling along with spatial identities which serve

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<sup>3</sup> Elites are defined as societal groups that exert influence in decision making as a result of their own economic, political or professional standing in society.

to ground the discussion in section five on the limits of political integration in multinational states. The final section of the paper draws some conclusions.

## 2. Conceptual Background

### 2.1 Institutions and Rescaling Mechanisms

The mechanisms of spatial rescaling are far from straightforward, yet new developments in the new institutional economics literature can be especially useful for understanding how self-interest or cultural motivations influence support for vertical scaling. Institutional thinking envisages spatial scales as determined by the extent of transaction costs and inherent benefits resulting from coordination games (North, 1990). Similarly, geographers and economic sociologists have long argued that the transformation of social identities acts as a first step in triggering rescaling (Smith, 1995). Far from being self-contained structures, old European states are subject to varying constraints and hierarchies resulting from their overlapping functions (Brenner, 2003). With the ‘demise’ of the Keynesian project, the development of economic integration in Europe and the ‘third wave’ of the democratisation processes (Huntington, 1991) sub-national identities have blossomed, and, as we argue here, they explain the resurgence of sub-national collective action<sup>4</sup>. However, state responses to collective sub-national heterogeneity are far from uniform. Generally they are determined by historical legacies that make them country-specific. In countries such as Canada, Switzerland and Belgium, and more recently in Spain and the United Kingdom, institutional accommodation of regional heterogeneity has taken place through governmental decentralization,

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<sup>4</sup> The examples are numerous. After successful referendums in 1997, the Scottish Parliament has control of many governmental functions. Belgium’s federalization of 1993-95 entitles Flanders to direct the election of sub-national assemblies, reform of the Senate, fiscal autonomy for linguistic communities and devolution of international responsibilities to the regions (Downs, 1998). Corsica had an autonomy referendum in 2003, in which autonomy was rejected by just 51%. Finally, Catalonia, the Basque Country and Galicia have had devolved political responsibilities since the early 1980s, and there are political movements that seek additional transfers of power from the state by means of further reforms in their legal relations with Spain.

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devolution, or state federalization. However, this process has simultaneously given rise to a set of complex hierarchies based on competitive interactions between levels of government rather than on authority (Marks *et al*, 1996).

Sub-state heterogeneity is generally characterized by the presence of regional languages and/or autochthonous cultures alongside the legal system and local economic institutions, which in turn, can strengthen the power of regional elites. When these sub-state communities become politically organized to exert collective action, they are termed 'stateless communities (nations)' (Keating, 2001)<sup>5</sup>. Identity in stateless communities compares to that of statewide groups in some objective factors, though only when collective action successfully ties identity with support for some form of state transformation are downscaling pressures enacted. When this takes place, old nation states become *de facto* multinational states, namely states holding up multiple national consciousnesses (Norman, 2002)<sup>6</sup>, irrespective of their legal recognition as nations.

The classical work of DiMaggio and Powell (1998) complements the economics literature by arguing that organizations compete not just for resources but also for political power and institutional legitimacy. In a similar fashion, state-wide and sub-state communities exhibit their own competition processes and institutional legacies<sup>7</sup>. Experiences of devolution are driven by similar factors; they differ in the triggers if sub-national demands for state rescaling and in the way the nation state responds to such demands. At a conceptual level, two factors have implicitly thought as drivers of state rescaling, namely identity and economy though there is no empirical evidence on their influence. The economy is argued to prevail in top down processes of devolution, whilst identity if identified as the driver in bottom up types. Although

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<sup>5</sup> There are a large number of stateless nations in Europe and other western states, including Catalonia, the Basque Country, Flanders, Scotland, Corsica, Galicia, Wales and Quebec among other.

<sup>6</sup> The state in this setting becomes a 'political entity' that governs institutions, while the nation functions as the 'imagined community' of members, with a sense of 'organic solidarity' that is not necessarily equivalent to a particular ethnic or minority group on the one hand or to the state on the other.

<sup>7</sup> Furthermore, economic development matters. Bahl and Linn (1992) claim that there is a specific economic development threshold below which decentralization may be ineffective.

the specific balance between economy and identity is specific, the two factors are not mutually exclusive.

Unlike other disciplines of social science, political economists have not paid much attention to the role of identity in explaining processes of state rescaling. Instead, the focus has traditionally been on fiscal burden sharing mechanisms and the efficiency of institutional designs dependent on size, openness and trade, all subject to the spillover effects of economic integration processes (Alesina et al, 1997, 2000 and 2003). Other literature emphasizes the effect of formal and informal competition and cooperation (Breton, 2000). Only recently, some institutionalist economists incorporate the role of identity in explaining the formation of nation states. Pagano (2003), drawing on Gellner's theories, argues that the economic development of western societies required a national state homogenisation that delivered cultural standardization, which in turn, decreased the costs of high mobility, particularly in urban areas. Cultural homogenisation led to a mutable division of power associated with market economics, which favoured the development of nation states<sup>8</sup>.

The specific combination of identity and economic incentives along with the competitive institutions that states set up to embrace heterogeneity explains the specific shape of today's state scale. Hence, the level of decentralisation of a state results from a combination of both. Devolution or decentralisation, by empowering regional elites (Breton, 1964) can be argued to foster competitive mechanisms between state-wide and stateless communities – so called vertical competition-, and thereby increase their control over government responsibilities (Breton, 2000) and accordingly incentivize collective action in more affluent regions (Gourevitch, 1980).

## 2.2 Economic Incentives

The economic theory of federalism examines the incentives and effects of interjurisdictional interactions between and among different levels of government as

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<sup>8</sup> However, there may also be resistance to the cultural homogenisation process that strives to incorporate these societies into a broader and expanding state (Hechter, 2000).

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resulting from the costs and benefits of each scale. In contrast, sociological approaches explore the interactions, social linkages and synergies (Jessop, 2002). The political economy literature brings together both mechanisms, and proposes different institutional arrangements to manage heterogeneous populations. The most characteristic example refers to the work of Frey (2008) who has developed the so called Functional Overlapping Competing Jurisdictions (FOCJ) theory to argue that the size of jurisdictions should functionally adapt to the functional specific problems. Although initially the theory lacked a reference to spatial identity, in a recent paper, Frey (2009) states that people's desire for embeddedness might act as a mechanism influencing the heterogeneity of institutional designs. Similarly, in the economic geography literature, other approaches call for the development of post-national states and city regions (Brenner, 2003).

The emergence of a single currency, traditionally a symbol of state identity, illustrates how the dimensions and the competences of European states are now too small to resolve large-scale, global problems independently. At the same time, the efficiency of European states (especially the most centralized ones) in resolving small problems has been called into question, especially at the time of a severe economic recession. More generally, the association between economic integration and state downscaling has been formally formulated in the Alesina "Size of Nations" works (Alesina et al., 2000). This literature goes on to argue that since the period of early nation building in the first half of the nineteenth century, country size has resulted from a trade-off between the 'benefits of market size' and the 'costs of population heterogeneity' (Wittman, 1999; Alesina and Spolaore, 1997). Economies of scale have encouraged state integration, though the benefits of size decline with economic integration and the expansion of trade integration. Similarly, heterogeneity increases with a country's economic size, as does the level of public discontent with the central government, which is seen lag behind in providing public goods to match heterogeneous preferences. The latter is especially prevalent in multinational states,

namely states embracing more than one spatial identity<sup>9</sup>. In the light of this evidence, Alesina et al. (2000) contends that small cultural or ethnic groups can benefit by forming homogeneous political jurisdictions, and their relative openness becomes a substitute for their small size. Indeed, after the Second World War, trade restrictions were gradually removed and the number of independent nations increased, especially the number of relatively small countries. Furthermore, trade integration makes home market less desirable for economic elites and internal lobbying less useful. At the same time, fear of competition for rents and of rent loss from the dissolution of national markets leads them to use instruments in hand to prevent European wide competition and national state disintegration. These are key tools to prevent competition are spatial identity – as a source of social embeddedness – and fiscal redistribution and, more generally, the management tools of a country's economic development, primarily tax powers and central state authority on strategic industries and infrastructures.

Given a sufficient degree of heterogeneity, when regions within a federation become more prosperous, political disintegration becomes more likely (Elligsen, 1998). In other words, the mechanisms underlying the state downscaling process can be summarized as a trade-off between benefits and costs of smaller scales by examining the effect of economic integration on the viability of small size states, the complexity and transaction costs of scaling down state activities, the resources obtained from re-balancing the fiscal redistribution burden as well as the overall political power and influence associated with the scaling down of state activities. Generally speaking, a rational evaluation of the net gain from state rescaling involves balancing the loss of traditional scale economies associated with larger country size, the costs of dealing with diversity with the benefits for market size which are affected by the degree of a country's openness (Alesina et al, 2002), as well as the costs of ameliorating - through redistributing and insurance- the regional fiscal burden and ensuring spatial identity recognition.

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<sup>9</sup> Indeed, a growing sense of dissatisfaction may foster a new national identity (Lustick et al., 2004) and the economic motivations behind secession are even stronger in those states, which happen to be ethnically similar (Young, 2002).

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Economic theory predicts that the disintegration of a nation might result from economic and fiscal considerations (Buchanan and Faith, 1987). Hence, not surprisingly, there is extensive evidence of the importance of regional redistribution in driving state rescaling in both the economics and political economy literature. Bolton and Roland (1997) find that poorer regions will prefer to join richer regions in order to maintain redistribution flows, while richer regions may prefer to go alone. Thus, the thread of political disintegration serves to limit regional redistribution; as richer regions are more likely to seek self-determination to avoid paying transfers to poorer regions (Buchanan and Faith, 1987; Young, 2002, Le Breton and Weber, 2001). Consistent with these observations, Hale (2000) demonstrates that the wealth of an ethnic region in the former USSR was a highly significant predictor of the speed with which sovereignty was declared. From this evidence we can conclude that regional imbalances are to increase support for vertical state downscaling (**Testable hypothesis 1**).

Unlike in the case of fiscal redistribution, evidence on the importance of spatial identity in rescaling processes is scarcer. Nonetheless, spatial identity is increasingly acknowledged as an important non-monetary pay-off of individuals' action, a 'metapreference' that embeds individual preferences (Akerlof and Kranton, 2000, Davis, 2006). Identity also provides 'symbolic utility' (Pagano, 2003) as well as patterns of social interactions (Scott, 1998). Hence, changes in the intensity of identity might capture disattachment with nation states, and explain support for vertical state rescaling. Similarly, we can conclude that an expansion of individual identity increases the likelihood of support for state downscaling (**Testable hypothesis 2**).

Finally, the nature of rescaling may be affected by the existence of process related costs, or more generally transaction costs<sup>10</sup>. Large transaction costs are expected to arise as a result of vertical downscaling processes if state-wide elites resist the process in the form of cultural grievances and economic conflict. Nonetheless, transition costs are complex to predict ex-ante as they depend on the politics of the

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<sup>10</sup> Indeed, Bookman (1992) finds that of the 37 secessionist movements examined (most occurring after the Second World War) only 12 were peaceful and in most of these cases violence led to enormous transaction costs

secession, and perhaps, the entrenchment of democracy in a country. Finally, in examining transaction costs one should include psychological costs, which determine support for institutional reform, institutional entrenchment, as well as myopia and integration campaigns by the states<sup>11</sup>. Next section follows up on this question by providing evidence on the extent of fiscal redistribution and the evolution of regional identity.

### 3. Two Case Studies: Catalonia and the Basque Country

This section explores the historical background, economic models of capitalism and experiences of political disintegration in Catalonia and the Basque Country.

The Spanish state is the product of the progressive integration and disintegration of kingdoms and territories in the Iberian Peninsula. Portugal gained independence in the seventeenth century, and in the sixteenth century Castilian (or Spanish) language became the ‘lingua franca’ with the exception of Catalonia and the Basque Country, where it was only spoken by the regional elites. During the eighteenth century, in an attempt to mimic centralisation processes in other nations, the rights of self-government of Catalonia were abolished. However, the attempt proved not as effective as in other countries after a few centuries. As noted by Linz (1993), nation building was not an easy business in Spain as it did not succeed in creating a national consciousness throughout the country. Spanish was not imposed as a single language until 1888 and was not declared the official language until 1931. The Spanish single market was not completed until 1876 with the end of the a set of civil wars – so called Carlist wars, - which removed as a result the fiscal and transport privileges of the Basque Provinces, and the single currency, the peseta, was introduced in 1868. Furthermore, the Basque Country and Catalonia were the only

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<sup>11</sup> Bookman (1993) stresses that secessionist movement’s gain strength as citizens come ‘to reappraise the costs and benefits of membership in the union’. In her view, the main issue behind the demand for political sovereignty is ‘economic injustice’, at times combined with ethnic, historical, cultural or religious factors.



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two Spanish regions experiencing some form of industrial revolution (Nadal, 1992), which in turn paved the way the development of a regional elites.

The historical pathways of Catalonia and the Basque Country were not parallel until the end of the XIX century. Catalonia, while still playing an important role within the construction of Spain, has tended to be at the losing end of conflict and wars. In contrast, the Basque Country has generally been on the winning side and therefore able to maintain, like Navarre, its historical privileges. However, the outlaw of both Catalan and Basque self-government alongside the rise of a regional elites resulting from the economic development of both region states lead to the blossoming of parallel nationalist demands both in Catalonia and the Basque Country - <sup>1</sup> The Catalanist Union was set up in 1891 and the Basque Nationalist Party in 1895.<sup>12</sup>. Unlike the Basque who participated from the very beginning form the Spanish empire, Catalans were left out of the empire, and only some Catalan elites benefited from full integration in Spain due to the removal of customs tariffs which allowed Catalans access to the Spanish colonies. Yet, the loss of Spanish control of Cuba and Puerto Rico in 1898, ended economic regional self-interest in a strong nation state, and weakened popular support for the nation-building project (Colomer, 2006).

Although Catalans and Basques cooperated with the Spanish state in different ways during the nineteenth and twentieth centuries, the success of cooperative agreements did not always proved positive. Most notably, cooperation failures include the the first republican experience 1873-4 (presided by two Catalan presidents and intending to set up a federal state), limited success in lobbying the state by Francesc Cambó, the Catalan Regionalist party leader who became treasury minister of a still undemocratic state in 1921 and even more important, the especially the breakdown of the Second republic (1931-36). Indeed, Catalan nationalism played an important part in the creation of the Second Republic, the period when Catalonia was granted some regional autonomy for the first time and the Catalan language was officially recognized (as was Basque). After the Spanish civil war and during the forty years of dictatorship that followed the Civil War; both languages were repressed and

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<sup>12</sup> The Catalanist Union was set up in 1891 and the Basque Nationalist Party was set up in 1895.

forbidden until the restoration of democracy in the late 1970s. The transition to democracy in the second half of the 1970s brought the reestablishment of Catalan and Basque institutions and the sharing of political power with the central state, primarily in areas of social policy and other responsibilities included in the regions' respective Statutes of Autonomy passed in the early 1980s<sup>13</sup>. Recognition was given to other stateless communities such as Galicia and other set of regions were created, most of them ex-novo. From a fiscal perspective, only the Basque Country (and Navarre) was granted tax autonomy; whilst Catalonia's tax administration was included in a centralized revenue collection system and a subsequent regional financing based on per capita allocation of public expenditure, which implied positioning Catalonia as a clear net contributor to other Spanish region states.

The downscaling of the Spanish state, has taken place in two specific waves. The first was immediately after the restoration of democracy 1978 until 2001, when the Spanish Constitution and the first regional Statues of Catalonia and the Basque Country were passed. In the years to follow the approval of the regional Statues, about thirty per cent of public expenditure, mainly covering social policies, culture and security, was transferred to region states as block transfers in the case of Catalonia –who was not given fiscal autonomy and was inserted in the regional financing system together with all ordinary regions-. Effectively, political decentralization allowed both the Basque and Catalan governments to design their own policies on health, education, social care, culture and language. Catalan and Basque became co-official in their respective regions and the main languages in education. Both Catalonia and the Basque Country set up regional TV channels; all civil servants are required to know the regional language and the education and health systems were modernized. However, whilst initially rescaling processes was part of a wider project democratisation of the state, asymmetric in granting autonomy to a few historical nationalities, after 2001 it became symmetrical when all region states were granted equal powers.

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<sup>13</sup> However, the decentralization backtracked after some members of the Spanish army, tried to regain power in a failed coup d'état in 1981.

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After 2002, a second vertical rescaling wave began, and was mainly a bottom up process. Indeed, both the Catalan and Basque governments unilaterally attempted to modify their institutional relationships with the Spanish state through reforms to their regional Statutes, which is the route offered by the Spanish institutional structure for implicit constitutional change (Colino, 2009). The Basque parliament passed a reform of the regional Statute with the support of 56% of its members, though it failed to obtain the approval of the Spanish parliament. For its part, the Catalan parliament managed to use their sub-national power of constitutional reform to propose a new Statute, which received the support of 91% of its members. Unlike the Basque, it was passed with heavy amendments by the Spanish parliament and approved in a referendum, but a ruling of the Constitutional Court after objections principally from the Spanish conservative party (the Partido Popular) outlawed its most important and decisive aspects in 2010. Finally, civil society has developed during the renegotiation of the Catalan statute, and local referendums of self-determination have been called in different major towns in Catalonia to act as legitimacy challenges to the constitutional equilibrium. Region states have gradually received an increasing tax powers although in 2007 tax revenues in the hands of region states accounted for no more than 13% of total fiscal revenues, with the obvious exception of the Basque Country and Navarra.

## 4. Empirical Evidence

### 4.1 Rescaling Mechanism I: The Economy and Regional Redistribution

Catalonia and the Basque Country together account for one forth of the Spanish GDP and one fifth of its population as well as 40% of its total trade (imports plus exports). Furthermore, the composition of region trade has exhibited marked changes. Whilst in 1986 90% of Catalan trade took place within Spain, by 2000 this figure had fallen to 53%, which explains why economic development strategies are not nested anymore within the context of the Spanish market. Catalonia is home to 16% of Spain's

population and it is a net migration receiver, while the relative size of the Basque Country has remained stable at around five per cent of the total. Population wise Catalonia compares to Denmark and Switzerland and the Basque population compares to some newly independent Baltic states<sup>14</sup>. Furthermore, the effects of regional redistribution are exacerbated in the case of Catalonia, as Catalonia participates, unlike the Basque Country has very limited tax powers. This is especially important because the modernization and the increasing intervention of the state in the economy have led to a change in the ratio of public expenditure/GDP, from 16 per cent in 1982 to 43 percent in 2001.

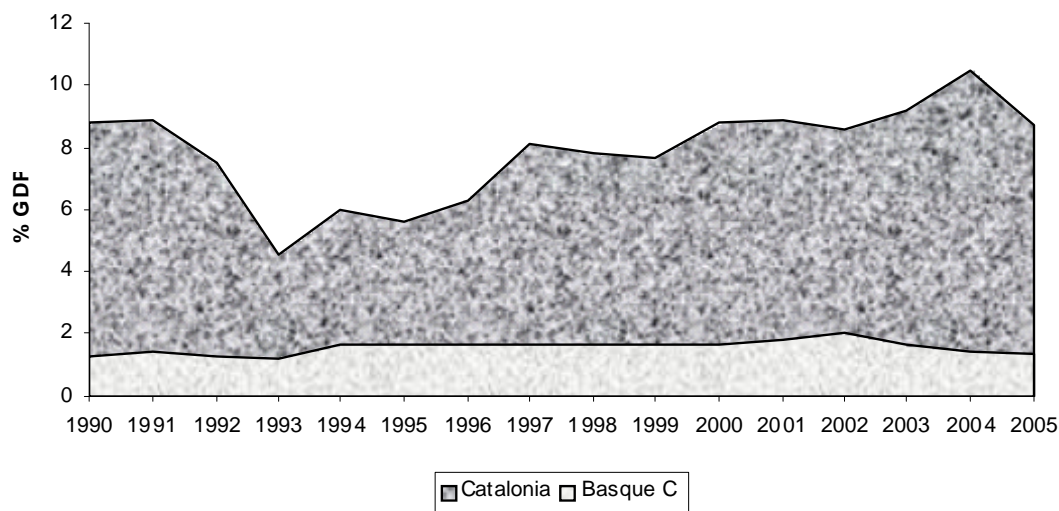
The extent of regional redistribution taking the form of regional fiscal imbalances vis-à-vis the rest of Spain as reported in Figure 1, and show, the Catalan fiscal deficit amounts to 8-10 per cent of total GDP, while in the Basque Country, due to its special fiscal arrangements (the Basques collect their own taxes and negotiate their contribution to Spain), the fiscal deficit, is not more than two per cent of GDP.<sup>15</sup> The Catalan fiscal deficit of 1997 (8.1% of GDP) was considerably higher than that of other contributor regions such as Bavaria (3.5%), Baden-Württemberg (4.4%), Île-de-France (4.4%), South East England (6.7%) and Stockholm (7.6%) (Pons Novell and Tremosa, 2005)

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<sup>14</sup> Although, as we noted in the introduction, if trade openness is a substitute for dimension, small states as Basque Country could be economically viable.

<sup>15</sup> The central government collects 90% of all Spanish taxes, while public expenditure is relatively decentralized: of the total Spanish public expenditure in 1998, 66% came from central government, 21% from regional governments and 13% from local governments (Ministerio de Economía y Hacienda, 1999).

**Figure 1:** Fiscal Imbalance of Catalonia and the Basque Country *vis-à-vis* the rest of Spain (% GDP)



Sources: Pons Novell and Tremosa-Balcells, 2005, , INE, Instituto de Estudios Fiscales, 2008.

Given that the Basque Provinces enjoy a special financial arrangement with the state<sup>16</sup>, regional fiscal imbalances with the Basque Country are more moderate (See Figure2) . In practice, the amount to be remitted by the Basque government has been based on a percentage of the difference between the national cost of the services not devolved to the region and the tax revenue not devolved by the central government, a curious concept that amounts to choosing a number somewhere between the region's income share and its population share – a percentage (6.24%) that has not been updated since 1981. Finally, it appears that Madrid has benefited the most from the 'decentralized Spanish model', due to the concentration of Spanish government investment and public expenditure in the capital. In 1998, some ten per cent of Spanish public capital stock was concentrated in Madrid (FBBVA, 2002)<sup>17</sup>. Hence, the question that arises is that of identifying the net gainers and losers from an

<sup>16</sup> This is due to historical agreement that allows them to collect all taxes within their territory (except customs duties) and remit a share to the Spanish central government. This remittance depends in principle upon an estimate of the cost of services provided in the region by the central government

<sup>17</sup> The macroeconomic effects of this process have been quantified elsewhere, though a simple look at the data shows that between 1990 and 2005 has experienced a progressive reduction in its share of Spanish GDP. In contrast, figure 1 shows that the Basque Country's share of GDP has not fallen significantly, despite its experiences of terrorism.

elimination of the existing mechanisms of fiscal territorial solidarity, to compute the net income growth had solidarity been contained.

The empirical strategy followed in this paper lies in first computing the so called “fiscal residuum”, namely the effect on regional mean income before and after clearing the fiscal regional imbalances in order to estimate the net effect of eliminating fiscal redistribution in the state. We use data from 2005 on regional income, consumption, public expenditure, imports and exports, and have territorialize on a population basis central level expenditure. To compute the fiscal residuum we have first obtained an income multiplier from income, consumption and tax revenue data. Then we compute the fiscal residuum of each region state in Spain, as the expenditure that the state undertakes in each region minus the inter-territorial transfers (see Brosio and Revelli, 2003 for an application to Italy and the appendix for a description of the methodology). Following standard macroeconomic equivalence, internal income ( $Y$ ) and external imports ( $M=mY$ ), equal consumption ( $C=cY$ ), private investment ( $I$ ), public investment ( $G$ ) in Catalonia (CAT) and elsewhere in Spain (SPN) along with exports ( $X$ ) as follows:

$$Y_i + M_i = C_i + I_i + G_i^{CAT} + G_i^{SPN} + X_i \quad (1)$$

Regional public investment is financed by taxes which depend on income ( $T = tY_i$ ) raised in Catalonia, a percentage  $\alpha$  of the taxes raised centrally in Spain ( $T^{SPN}$ ) and transferred from the Spanish government ( $TR^{SPN}$ ) as follows:

$$G_i^{CAT} = T_i^{CAT} + \alpha T_i^{SPN} + TR_i^{SPN} \quad (2)$$

The fiscal residuum (FR) is computed by the difference between public expenditure in Spain and transfers to elsewhere in Spain, and the fiscal contribution of Catalonia to the rest of Spain – so called fiscal residuum ( $FR^{CAT}$ ) – is as follows:

$$FR_i^{CAT} = G_i^{SPN} + TR_i^{SPN} - (1 - \alpha)T_i^{SPN} \quad (3)$$

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Finally, inserting (3) and (2) into (1) we obtain (4) below which is a simple multiplier model where  $m$ ,  $c$ ,  $t$  are propensities to import and to consume, and  $t$  refers to average tax rates in Spain (SPN) and Catalonia (CAT) respectively. From (4) Hence, it is possible to estimate the regional income forgone from regional redistribution by calculating the income differential between the status quo and a scenario where the fiscal residuum would be cleared ( $FR=0$ ) as follows:

$$Y_i = \frac{1}{1 + m_i - c_i - t_i^{SPN} - t_i^{CAT}} (I_i + X_i + FR_i) \quad (4)$$

The results of this exercise are presented in Table 1 and reveals, assuming a linear taxation system, the effects on average income of a downscaling process leading to clearing the fiscal residuum. Extremadura would loose 23 % of its income, Asturias 17% and Andalucía and Castilla about 10%. Even the region of Madrid would loose about 4% of its GDP. The net gainers besides Catalonia (37%) include Valencia (17%), the Balearics (20%) and Navarra (17%). Then used in the following section to estimate how it would impact support for redistribution.

**Table 1:** Estimated impact on the Spanish regions' means income when the fiscal residuum is zero in 2005

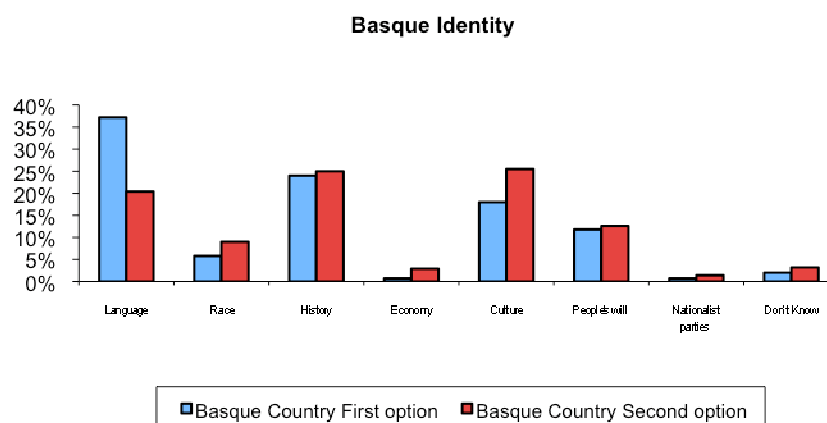
	Gross Mean Income Fiscal Residuum (before rescaling)		Predicted Mean Income Income Multiplier (after rescaling)	Change
Andalusia	173,708	4,369.5	3.9	156,580 -10%
Aragon	35,295	-171.7	2.6	35,744 1%
Asturias	38,120	1,492.3	4.2	31,821 -17%
Balearics	13,898	-1,062.5	2.6	16,674 20%
Canary Islands	22,825	866.7	2.3	20,871 -9%
Cantabria	14,252	-281.7	3.8	15,333 8%
Castile-Leon	64,693	2,398.0	2.6	58,501 -10%
Castile-La Mancha	38,757	1,313.7	2.7	35,155 -9%
Catalonia	114,084	-20,085.5	2.1	156,541 37%
Valencia	90,222	-5,328.6	2.8	105,265 17%
Extremadura	34,461	1,907.3	4.2	26,529 -23%
Galicia	70,812	2,291.2	2.7	64,621 -9%
Madrid	107,791	2,092.8	2.0	103,696 -4%
Murcia	20,694	194.9	2.2	20,266 -2%
Navarre	11,778	-695.1	1.6	12,897 10%
Basque Country	41,053	-3,434.4	2.1	48,196 17%
La Rioja	6,637	-13.9	2.7	6,675 1%

Source: Instituto Nacional de Estadística, Contabilidad Regional de España, several years 2005

## 4.2 Rescaling Mechanism II: The evolution of Spatial Identity

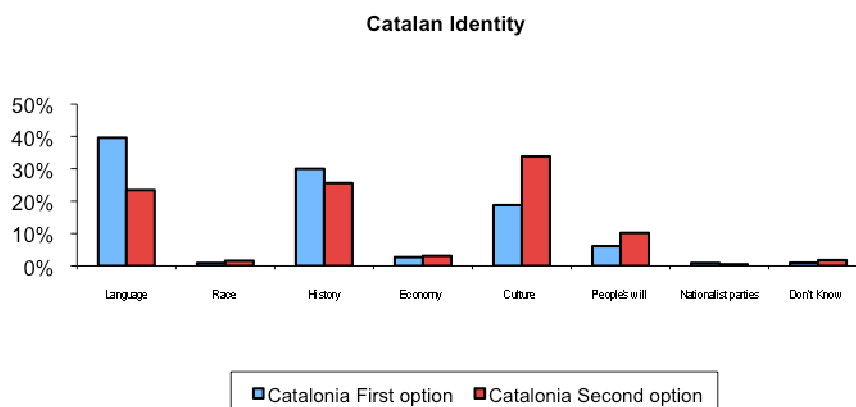
Along with economic incentives, identity – both cultural and political – is an important determinant of the cohesion of stateless communities.<sup>18</sup> Identity acts as a uniting factor that complements that of state institutional structures (Jones and Smith, 2001). Figure 2 presents the main features of Catalan and Basque identity. Interestingly, the three primary features are: language, culture and, especially in the Basque country, “democracy” or “participation”. Another important difference is that some 6% of Basques equate their identity with “race”, whereas this association is practically non-existent in Catalonia. Hence, this descriptive evidence suggests that with few exceptions, for the vast majority of Basques and Catalans, identity and the economy are two almost independent sources of influence of support for state rescaling. .

**Figure 2: Sources of spatial identity**



<sup>18</sup> This section is devoted to the empirics of perceptions of self-determination. The results are taken from two surveys conducted in September 2002 in Catalonia and the Basque Country by the Sociological Investigation Centre in Spain (study 2455). That survey explores the perceptions of both regions with regard to 'institutions and autonomies' and is a stratified multiple stage survey representative of each region-state.



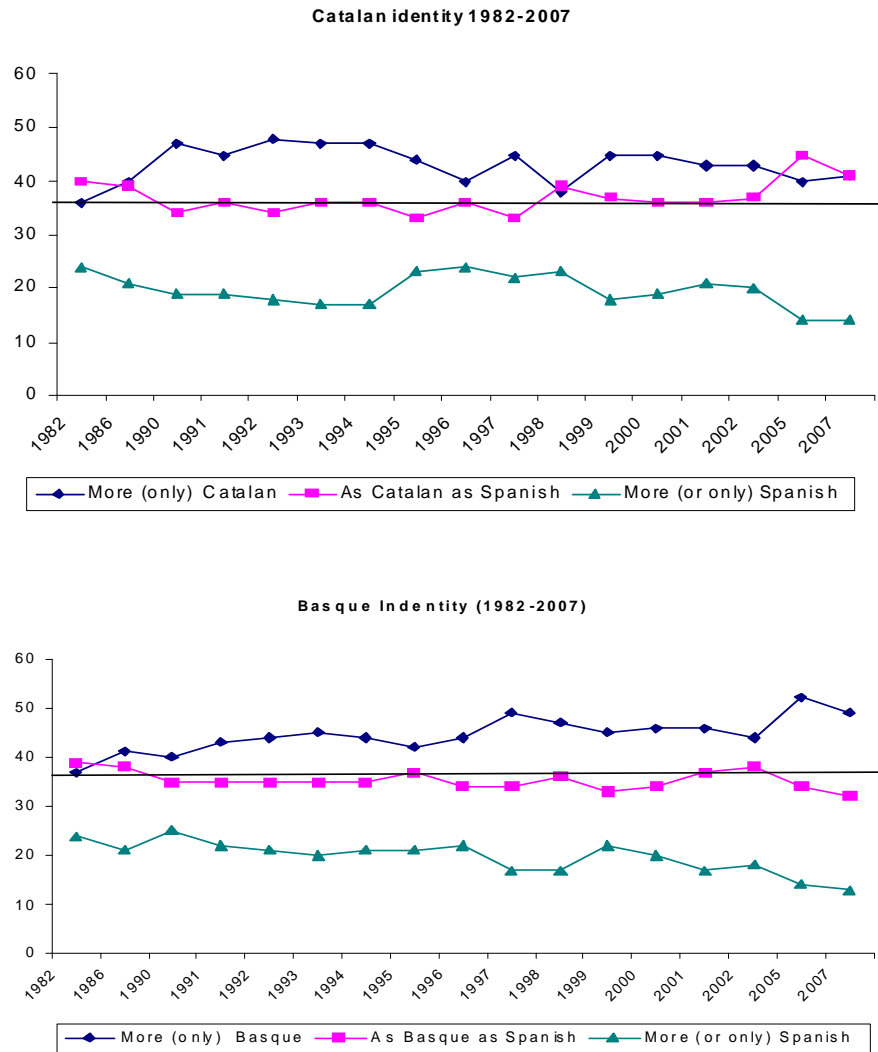


*Source: CIS, 2001.*

Figure 3 plots the evolution of state-wide and steles identity in Catalonia and Basque Country from 1982-2007. Over the space of 25 years perceptions of spatial stateless identity have evolved, consolidating and expanding in Catalonia and blossoming significantly in the Basque Country. This has taken place in a period of increasing immigration mainly from Latin-America and North Africa, which one would expect to have weakened spatial identity, as ethnic heterogeneity increases as a result. However, we find that both in Catalonia and the Basque Country shared identity remains relatively stable, while identification with Spain or the state is steadily declining; whereas in 1982 only 11 per cent of Catalans defined themselves as only Catalan, the share increased steadily to 17 per cent in 2002, and the share of those who see themselves as more Catalan than Spanish increased from 25 to 27 per cent over the same period. The share of the population that see themselves as either Spanish or only Spanish has declined from 24 per cent to 20 per cent; the share of those with 'dual identity' represented the majority at 37 per cent in 2002. Similar patterns are found among the Basques; while 21 per cent perceived themselves to be only Basque in 1982, by 2002 the proportion had increased to 26 per cent and those perceiving themselves as more Basque than Spanish had increased from 16 to 18 per cent, while those seeing themselves as Spanish or more Spanish than Basque decreased from 24 per cent to 18 per cent. Again, given that dual identity responses are focal points as they imply a "no choice" or "no conflict" option for some respondents Figure 3 reveals that both Catalan and Basque spatial identity have experienced and expansion from 1982 and today compare - in the case of Catalonia-

and exceed – in the case of the Basque Country- the percentage of people expressing dual spatial and state-wide identity. Both in Catalonia and in the Basque Country, sole identification with Spain has halved in a generation.

**Figure 3: Identity in Catalonia and the Basque Country (%)**



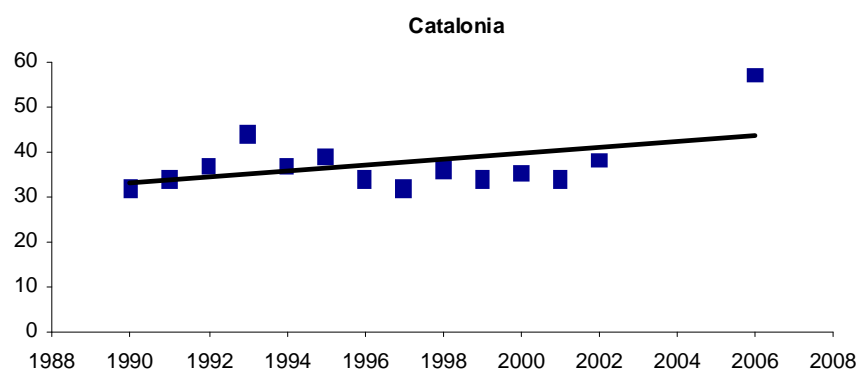
Source: CIS different issues (1982-2007).

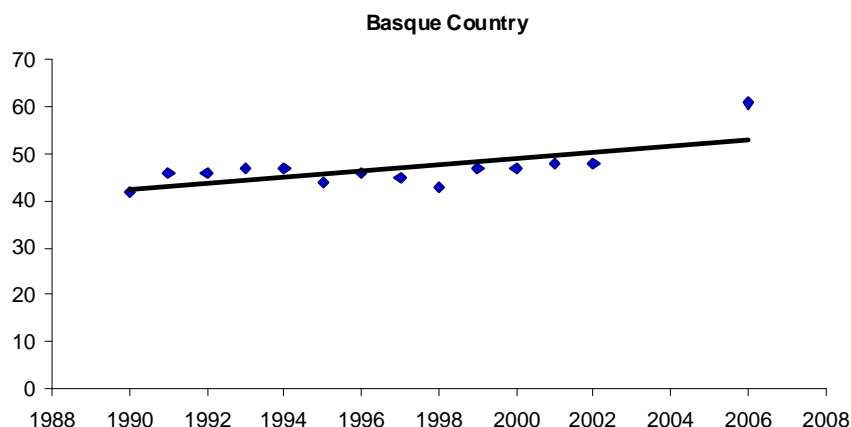
*Question:* Which of the following expresses your feeling of attachment? I am only Spanish, more Spanish than from my region, as from my region than Spanish, more from my region than Spanish, and only from my region.

## 4.3 Support for vertical state downscaling

Previous research has argued but not tested that both the economy and identity are factors that influence state rescaling. One way of testing this claim is to examine the variables that explain the empirics of spatial state downscaling in the form of support for further devolution of state responsibilities to region states. Figure 4 displays the patterns of support for different state institutional structures from 1990 to 2005. Interestingly, support for independence reaches 34% in the Basque Country, while in Catalonia it is around 19%, though a large majority support a federal state reform. Figure 4 also shows that from 1982 to 2005 the sense of attachment to a certain conception of Spain has declined markedly and after 2002, when the Statutes were about to be reformed a majority of Basques and Catalans supported either a federal or an interdependent state, indicating support for a reform of the institutional status quo. In 2002, respondents both in Catalonia and the Basque Country expressed high levels of dissatisfaction with their level of political autonomy: 61% of Catalans and 53.4% of Basques stated that they would like their political autonomy to increased. This evidence suggests that devolution as its stands does to satisfy neither the Catalans nor the Basques, and that support for institutional reform is increasing. That is, a majority is in favour of further vertical state downscaling. Again, the question on the role of changes in identity and fiscal redistribution is still to garner enough empirical evidence. Which what we will proceed to do in the sect section.

**Figure 4:** Preferences for a vertical state rescaling (%) (Support for a Federal or independent State)





Source CIS different issues (1990-2006).

*Question:* Here enclosed are a set of alternatives organizational forms of the state in Spain. Please tell me which one you agree with? A sole state without autonomous communities, a state with autonomous communities as today, a federal state with more autonomy to the autonomous communities or a state with autonomies communities that have can become independent states.

Table 2 reports the results of a regression analysis (using a probit model and marginal effects to be interpreted as coefficients) where the dependent variable is support for vertical downscaling of the state ( $Y_{ij}$ ) in the form of a federal or independent state where regions have greater autonomy, and it is explained by changes in regional identity ( $RI_{ij}$ ), fiscal imbalances ( $FR_{ij}$ ) for each individual  $i$  from each region  $j$  and specific individual characteristics ( $\eta$ ). As a result unobservable variables associated with regional imbalances might be picked up, although on the other hand, the heterogeneity resulting from seventeen region states in Spain makes the identification less problematic.

$$Y_{ij} = \beta RI_{ij} + \delta FR_{ij} + \eta_{ij} + \varepsilon_{ij} \quad (5)$$

To estimate this model, we use data from a survey designed by the Spanish Centre for Sociological Research containing information on regional identity and fiscal imbalance. The two treatment variables of the model are regional identity (measured on an intensity scale from 1 to 5) and exposure to territorial fiscal imbalance (measured by the same year estimates of the fiscal imbalance, using the most

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conservative estimate). I consider three controls: age, gender and social status.<sup>19</sup> I first report the full model with all the covariates together and including an interaction term between elites and fiscal imbalance, and then examine the consistency of the two “treatment variables”, namely identity and fiscal imbalance (fiscal deficit) alone. Fiscal imbalance is a regionally defined variable by definition it takes the same value within the region. We produce different estimates with a reduced form where all variables are included in specification (1), only identity is included in the specifications (2)-(3) and only fiscal imbalances are included, in the specification (4).

Consistently with expectations, Table 2 suggest that both fiscal imbalance and regional identity are significant covariats and exert a robust effect on preferences for vertical state downscaling; however, the marginal effect of regional identity is seven times higher than that of the fiscal deficit, and suggest that doubling regional identity results in an 15% increase in support for opting out. Overall, these results suggest that support for vertical state downscaling among the general public is primarily driven by identity<sup>20</sup>, or factors that correlate with identity. The other variable that exhibits a high coefficient is a dummy variable for the respondent qualifying as professional elite, which we compute from professional status, and interact with fiscal imbalances to measure self interest motivations of state downscaling. Hence, consistent with the view of the literature on economics of nationalism (Breton, 1964) and more generally, with the idea of rescaling being elite induced, a reasonable interpretation of the results in Table 2 is that support for state rescaling reflects self-interest on the side of those who expect to replace existing state-wide elites in their territories. Finally, controls suggest that support for downscaling is found to be larger among younger men.

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<sup>19</sup> However, the estimates of the controls variable deserve some comment: as expected, we find that younger; male and more affluent respondents are more likely to support state downscaling. As a result unobservable variables associated with regional imbalances might be picked up, although on the other hand, the existence of seventeen regions in Spain makes the identification less problematic. Although a panel data that contained evidence on awareness of fiscal deficits would have been ideal, that data was not available.

<sup>20</sup> However, the estimates of the controls variable deserve some comment: as expected, we find that younger, male and more affluent respondents are more likely to support state downscaling.

**Table 3:** Preferences for State rescaling (probit model marginal effects) in 2006

	(1)	(2)	(3)	(4)
Identity	0.149** (0.005)	0.146** (0.005)	0.143** (0.005)	-
Fiscal Imbalance	0.01** (0.001)	-	-	0.02** (0.001)
Male	0.047** (0.009)	0.05** (0.009)	-	
Age (years)	-0.002** (0.0002)	-0.002** (0.0003)	-	
Elite	0.07** (0.01)	0.11** (0.01)	-	
Elite*Fiscal Imbalance	0.03* (0.01)			
Pseudo R sq	0.10	0.09	0.06	0.02
N	9515	9515	9914	9914
Likelihood	1189.67	953.4	737.87	224.54
Ratio Test Chi (2,8)				
Log Likelihood	-5245.6	-5363.8	-5684.46	-5941.12

\*\*Significant at 1% level.

## 5. Conclusion

The mechanisms of vertical scale downscaling are largely ignored in the political economy literature. Europe offers some interesting case studies where to explore how state rescaling takes place. This article attempts to contribute to this debate by drawing on the interdisciplinary social science literature on state rescaling and political integration to understand the process of vertical downscaling in Europe. The first part of the paper has sought to explore the mechanisms that underpin vertical state downscaling, using empirical evidence from two region states in Spain, Catalonia and the Basque Country. We contend that increasing awareness of sub-national identities and economic self-interest (to halt regional redistribution) both associated with the competitive process of spatial scattering of political power. Similarly, following economic theory (Buchanan 1991, Alesina, 2002; Brosio and Revelli 2003) we examine how much regional redistribution influences preferences for vertical spatial rescaling. This evidence speaks to the processes of vertical state

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upscaling, and more specifically to the importance of building a European spatial identity as well as the limits of regional redistribution.

The empirical case studies examined here suggest that demands for further self government and self-determination have risen significantly since 1982, primarily due to the rise in sub-national identity, in the Basque Country, and together with the rise in the fiscal redistribution in Catalonia. Findings point towards a process of expansion of sub-state identity from 1982 to 2007 that has paralleled a rise of regional fiscal imbalances between Catalonia and the rest of Spain.

Drawing upon a multiplier model, I have first estimated the effect of clearing regional redistribution on each regions average income. Secondly, I have used these evidence together with evidence on peoples attachments to their spatial identity to examine how much it explains support for further state downscaling. Finally, we have tested whether downscaling is an elite driven process, following the economics literature.

Regression analysis suggests that the influence of identity in triggering support for state downscaling is more significant and important on overall magnitude than the regional redistribution. This evidence is consistent with the nation state downscaling view (Omhae, 1995), which predicts that in a globally interdependent world, nation-states progressively loose strength. Nonetheless, whilst Omhae described the process of rescaling at an aggregate level, this paper attempts to understand its microfoundations, namely whether state rescaling is primarily an elite driven concern, putting a break to regional redistribution and/or an identity driven mechanism. It is found that the effect of regional identity *vis a vis* their nation state identity is seven times larger to that of regional redistribution (depending on whether interaction term are or are not taken into account). However, as expected, we find evidence of elite induced downscaling, namely that respondents who are regional elites themselves are significantly more likely to support state rescaling processes. Although these results should be treated with caution (as they come from cross sectional data), they are suggestive of the role identity and the economies have in driving state rescaling processes.

All in all, as the evidence of this paper suggests that political recognition of sub-state identity does play a role in the process of vertical state downscaling. That is, if organic solidarity is not located at the state level, the proliferation of sub-national identities along with the development of a strong regional elite, can give raise to some support for state downscaling. However, the speed and the direction of the recalling process are still uncertain. In the light of this study, we can conclude that downscaling depends on how best each nation state can accommodate the proliferation of spatial identities and elite economic interests.



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European Institute  
London School of Economics  
Houghton Street  
WC2A 2AE London  
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