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Cultural Diversity and Economic Solidarity*

1. Introduction

Cultural diversity creates obvious problems for the institution and operation of markets. It substantially reduces the liquidity of resources and raises major obstacles against their mobility. It also encourages identification with particular groups**,** which restricts economic solidarity and often impedes forms of reciprocal insurance outside the boundaries of those groups.

The creation of a common culture and common European institutions must be recognized as a precondition to mobility and exchange; it cannot be taken for granted, as it happens when a purely competitive view of the relation among states is adopted. In order to make this point, this paper starts by discussing and integrating two different perspectives on the relation between cultural diversity and economic relations. The first considers cultural heterogeneity as exogenous, and studies how it can be an obstacle to economic development and redistribution, by inhibiting convenient economic relationships (in particular, reciprocal insurance contracts), and how it can explain the characteristics and the evolution of economic and political institutions.

The second point of view has been most thoroughly formulated in the works of Ernest Gellner and emphasises that economic transactions require preconditions—

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among them an endogenously determined level of cultural homogeneity—that are themselves the outcome of a political process. Although the latter perspective is less frequently considered, it can be traced back to an authoritative tradition.

In this paper we consider the merits of these two points of view. We argue that both of them should be taken into account if a balanced view is to be given of the complex relationship between cultural diversity and economic solidarity within the context of European integration.

The next section discusses the approach prevalent in economic theories that takes cultural diversities to be endogenously given (like preferences in neoclassical theory) and analyses the relationship between cultural heterogeneity and economic policies on this basis.

The third section considers Gellner's thesis that the national states have played a crucial role in the formation of market societies. By creating a common national identity, Gellner argues, they have superseded the marked cultural diversity that typified agrarian societies because the social and geographical specificity of large part of human resources greatly inhibited the institution of markets. Creation of the 'macro-institutions' of capitalism largely endogenized the level of cultural homogeneity and has made analysis of two distinct problems possible. The first of these problems concerns the complementarity between economic solidarity and cultural diversity, because the former, according to Gellner, may also influence the latter. The second problem is that the endogenization of cultural diversity enables cultural standardization and economic solidarity to be used as substitutes, in that both of them are devices that insure individuals against the risks typical of market societies. Individuals can, in fact, obtain just as much well-being from a higher level of standardization (which gives them a greater likelihood of finding alternative employment should they lose their jobs) as they can from a higher level of social protection (which, for example, pays them adequate unemployment benefit as they search for new employment).

The fourth section of the paper compares the USA and the European Union, pointing out that the latter is confronted by the following paradox: whilst the marked cultural diversity existing within the European Union makes standardization policies extremely costly, it may also increase the cost of adequate social protection policies which might be a substitute for standardization. As the French and Dutch referendums on the European Constitution have shown, it is for this reason that European integration may be undermined on two fronts: on the one hand, by excessive standardization; on the other, by scant social protection.

Finally, the concluding section argues that the project of European integration arises more from the ‘Hobbesian’ problem of creating common institutions stressed by Altiero Spinelli, Robbins and the other English federalists, than it does from the ‘Smithian’ problem of fostering competition among nations, and that these roots of the project for European unity should be borne in mind amid Europe’s current difficulties in order to promote a greater community where cultural diversity is not incompatible with common cultural standards and competition is supported and integrated by social solidarity.

2. Heterogeneity and economic theory

As mentioned in the introduction, the view predominant among economists is that cultural differences among individuals are the exogenously given basis on which to identify the most appropriate institutional arrangement (optimal level of centralization, the amount of redistributive expenditure, spending on public goods, political form) and thus to study all the effects of heterogeneity on economic performance.

Heterogeneity, well-being and economic performance

It is widely believed by economists that heterogeneity (racial, ethnic, religious, cultural) may have harmful effects on a community. This may depend firstly on the fact that the degree of heterogeneity may directly enter the utility function because individuals attribute positive value to membership of a group of individuals similar to themselves (Alesina and La Ferrara, 2000).

Secondly, it is possible to argue that associated with greater heterogeneity is a decrease in the benefits deriving from the provision of a public good. The explanation for this is straightforward if heterogeneity gives rise to a greater variance in preferences relative to the quantity and quality of the public good provided, as in this case the 'distance' between the preferences of each individual and of the median voter is higher on average. The nexus between ethnic diversity and the possibility of implementing public policies is dramatically evident in developing countries[1].

The idea that associated with a greater dispersion of preferences is a lower average level of satisfaction with public goods is at the basis of Alesina and Spolaore's analysis (1997; see also Alesina, Spolaore and Wacziarg, 2000) on the optimal size of nations. If an increase in size (because of the inclusion of 'peripheral' populations) augments heterogeneity, and if besides these costs we take account of the benefits deriving from size (the presence of scale economies in the production of public goods, the advantages accruing from the breadth of the market, the internalization of political externalities, or the possibility of mutual insurance among regions), we have a trade-off which enables us to 'close' the model. Optimal number and size will be such that the optimal balance is achieved between the costs of heterogeneity and the advantages of larger size. They are, that is to say, determined by the rational choice of individuals, given their preferences regarding public goods.

Moreover, greater heterogeneity may corrode the reputation mechanisms that support individual interaction in a context of repeated transactions, given that both sanctioning devices and reciprocity mechanisms are more effective, the more homogeneous the group (La Ferrara 2003; but see also Greig, 1993).

Alesina and La Ferrara (2005) consider these arguments to be partly countervailed by some benefits of the heterogeneity of the population: if cultural or

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[1] Easterly and Levine (1997) consider the effect of ethnic diversity on development in Africa. They find evidence supporting the thesis that ethnic diversity induces polarization and rent-seeking behavior, thus reducing consensus on the provision of public goods essential to development.

ethnic differentiation gives rise to differentiated skills in an economy, a heterogeneous society will be able to achieve a better division of labour and greater innovation. In support of this thesis, Alesina and La Ferrara cite the theoretical works of Hong and Page (1998) and Alesina, Spolaore and Wacziarg (2000), who formalize the existence of a positive relation between variety (or individuals and inputs) and performance.

Cultural heterogeneity gives greater opportunities to achieve an advantageous division of labour. This clearly echoes the idea that a 'melting pot' on the American pattern may produce the reciprocal enrichment of communities and give greater dynamism to the economy.

Various empirical studies seemingly confirm that, while the relationship between heterogeneity and economic performance is negative for low levels of development, it becomes positive for higher levels of income (in the presence of democratic political systems).

Heterogeneity and solidarity

A positive relation is commonly observed between the degree of cultural homogeneity and the extent of welfare policies. Alesina, Glaeser and Sacerdote (2001) attribute the lower level of redistribution in the USA, compared with individual European states, partly to greater ethnic fragmentation.

The thesis that cultural heterogeneity within a community may generate tensions inhibiting the development of economic solidarity (i.e. the view that cultural homogeneity and solidarity are fundamentally complementary) can be justified on the basis of numerous mechanisms (Van Parijs, 2004).

Firstly, cultural differences structure the channels of communication and exchange, dividing society into sub-units (which may undermine 'civic' solidarity), and reducing consensus for redistribution traversing the boundaries of each unity. Redistribution loses legitimacy among the less well-off if the more affluent are clearly perceived as belonging to a distinct group, and if linguistic racial, ethnic, and religious differences overlap with social and economic ones in respect to which the redistribution takes place.

Secondly, the presence of linguistic and cultural barriers may reduce cohesion among non-affluent groups if these are fragmented, thereby obstructing association in the collective organizations (trade unions, pressure groups) which often advance demands for social protection.

Indirect evidence of the inverse relationship between heterogeneity and solidarity is also provided by empirical studies demonstrating that ethnic differences within a group reduce the level of contribution to the supply of public goods (La Ferrara, 2004).

Some critical remarks

As highlighted by the many analysts, the main difficulties in interpreting the inverse connection between heterogeneity and solidarity stem from two facts.

In the first place, the concept of heterogeneity is not unequivocal, and different specifications of it may have very diverse economic implications. For example, consider the differing implications of two forms of heterogeneity, such as *local* diversity, i.e. the coexistence on the same territory of different communities (e.g. immigrants in urban areas, ghettoes, the case of Northern Ireland) and *territorial* diversity between different yet homogeneous areas constituting a single national unit (e.g. Belgium).

In the second place, the characteristics of the solidarity-delivering institutions are also of great importance. For example, consider the difference between welfare policies providing benefits linked to labour-market participation, which may encourage integration, and means-tested policies, which—by introducing a high implicit marginal tax rate on lower levels of income—may instead discourage the regularization of the informal economy and increase alienation among disadvantaged ethnic groups (immigrants for example).

These brief remarks suffice to counsel some caution in the interpretation of cross-country data, which necessarily involve simplifications and lump dissimilar phenomena together. They also suggest that these are matters requiring careful empirical analysis and a solid theoretical basis that are apt to single out the relevant dimensions of heterogeneity.

Here, however, we shall concentrate on a more general criticism that has a close bearing on some of the arguments developed in the next sections. A shortcoming, apparent in many of the studies cited above (and particularly evident in empirical analyses), is that they do not provide a sufficiently 'objective' definition of the variable subject to analysis.

The nature of the heterogeneity, taken as the independent variable, is surprisingly contingent on the particular community being studied. In the United States, skin colour and ethnic origin are of particular importance, while religion assumes secondary significance. Elsewhere, the principal dimension is instead linguistic (e.g. Belgium). In Northern Ireland religious membership prevails over other characteristics. This is the problem of the so-called 'salience' of a certain dimension of heterogeneity.

It has been suggested that, in order to deal with the problem, one must 'identify correctly for every country what the salient divisions are' (Feardon, 2003). Apart from the logical circularity of assessing the importance of heterogeneity by identifying its dimensions on the basis of the fact that they are important, we maintain that this solution conceals the fact that the nature and degree of heterogeneity may be viewed as more the effect than the cause of economic processes.

The question can be addressed at a deeper-lying level. The extent to which the problem of identity is central to disciplines different from economics is well known. Historians, sociologists, psychologists, and philosophers have provided explanations of the processes of identity formation at various levels (the nation, gender, group, etc.). However, these explanations differ from the economic one in its neoclassical version in that they emphasise the artificial ('constructed') character of cultural, ethnic, national, and even gender identities. The findings of these disciplines therefore suggest that the cause/effect relation can be reversed: although it is undeniable that the presence of heterogeneity affects public policies and economic performance, we may nonetheless ask how economic processes and institutions and public policies have led to the predominance of certain identities, or to the development of differing degrees of homogeneity, etc.

For example, it is indubitable that crucial processes in historical evolution of recent centuries have been driven by an endeavour to modify the degree of homogeneity by altering people's perceptions of their identity (consider the role of ideologies and, in particular, the role of nationalisms examined in the next section)—and perhaps to a greater extent than cultural differences have determined political aggregations, as neoclassical economic theory suggests.

Why is it that, in a particular context, a difference with respect to a certain dimension acquires economic significance while in other contexts it is irrelevant? The nexus among heterogeneity, economic institutions and political processes is undoubtedly much more complex than is implied by the inclusion of heterogeneity among the 'fundamentals', that is, among the exogenous variables. We should instead envisage these three variables as co-determinants, so that the differences are endogenous to economic development and to patterns of political interaction.

This endogeneity concerns also the relationships among the characteristics that differentiate among individuals. The possibility of differentiation according to a characteristic may depend on the presence, or the absence, of other common characteristics. On the one hand, differentiation according to one characteristic may increase differentiation according to another. On the other hand, the grouping of individuals according to particular characteristics (which, as we shall see, is one of the advantages of federalism) can often only happen if certain other differentiating features are absent. In both political and economic markets, the mobility of individuals, leading often to the formation of heterogeneous groups, is implicitly assumed, but creation of those markets requires the elimination of numerous specific differences and characteristics, that is a high degree of homogeneity in some other relevant dimensions. In the next section, we will try to show that it can only be achieved by means of processes and institutions which are often ignored by current economic theories.

3. The creation of the national states: cultural homogeneity and economic solidarity as substitutes

Neo-institutionalist theorists have stressed that the complexity of institutions is often due to the specificity of resources, or in other words, to the scant liquidity of many of the investments necessary for economic transactions. A resource is said to be ‘specific’ when its value is reduced significantly outside its current or planned use; conversely, a resource can be ‘generic’ (or ‘liquid’) if it has many possible uses.

Williamson (1985) has shown that, when the hypothesis of resources specificity is joined together with the hypotheses of contractual incompleteness and agent ‘opportunism’, if transactions are relatively frequent, forms of private governance (often sophisticated ones) tend to emerge. The firm, with its internal system of incentives and sanctions, is maybe the best example of private governance ordering.

However, in many cases, private institutions like the firm may perform a ‘second-order’ or residual role with respect to the macro-institutions, on which we focus in the present paper. Of great importance in this respect are the writings of Ernest Gellner (1983, 1998, 1999), who has emphasised the role performed by the national states in creating the conditions that have made numerous resources multi-purpose and liquid.[2]

In Gellner’s view, the main difference between agrarian societies and capitalist societies consists less in the degree of the division of labour—since this is very marked in the former as well—than the mobility of the resources required by the process of creative destruction intrinsic to the capitalist system.

The agrarian societies, which preceded the advent of capitalism, were

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[2] For a survey of Gellner’s works which emphasises their importance for the economic literature, see Pagano (1995, 2003). Other approaches, e.g. Anderson (1991), stress the need for identity (recently considered also by Akerlof and Kranton, 2005) as one of the essential ingredients in the formation of national states.

characterized by a marked cultural diversity, both horizontal and vertical, which rendered large part of resources 'specific'. This 'specificity' was much greater than the limited specificity that neo-institutionalist theorists view as characterizing capitalism. It prevented an individual from using a certain skill, or a certain body of knowledge tied to a trade or a craft, outside the local context in which s/he happened to live as a member of that social organization.

Very different dialects were spoken even in neighbouring villages, and the various classes had different languages, customs and traditions. Far from being a problem for the workings of pre-industrial economies, though, this high degree of specificity instead favoured the invariant reproduction over time of the same social and economic structure.

By spreading—and often also by inventing (Hobsbawm, 1992; Hobsbawm and Ranger, 1983)—a homogeneous culture and traditions, the national states eliminated the multiple specificities that had restricted both horizontal and vertical mobility in agrarian societies. Once mobility became possible, it helped reinforce cultural homogeneity, thereby generating a process of reciprocal support between resources mobility and reduced cultural diversity.

The extension of common codes of communication, the sharing by a larger community of the same language and the same institutions—in short, a homogeneous culture—made the costs of investing in human capital easier to bear, because the consequent ability to respond to adverse shocks through mobility provided individuals with insurance against these risks, as when displaced workers transferred their skills to other regions or other sectors.

The increased liquidity of resources favoured innovation and creative destruction, restricting the likelihood that expectations of future failures might inhibit the investments necessary for innovation.

The creation of the macro-institutions necessary to augment the liquidity of resources, and thereby make a market economy possible, was a process neither straightforward nor automatic. Agrarian institutions have dominated large part of human history, and only in very specific historical conditions has it been possible to break away from these forms of economic organization.

In agrarian economies, the presence of numerous cultures specific to territories and social classes immobilized and stagnated societies in which cultural barriers prevented individuals from being remunerated for their abilities. At the same time, the immobilism of those societies favoured their cultural differentiation and thus created a highly stable institutional equilibrium, which was very difficult to leave.

Two conditions engendered a relation of reciprocal reinforcement between mobility and cultural homogeneity, thereby fostering transition to a modern industrial economy. The first was the presence of a political authority with dominance over a particular territory. The second was the existence of a 'superior culture', which because it was recognized as such by the majority of the population, could be easily established by the political authority in the territory under its domination. To use Gellner's terminology, the ideal conditions enabling creation of the macro-institutions complementary to a market economy were the presence of both a 'groom' (a state with dominion over a particular territory) and a 'bride' (a superior culture recognized as such). Their 'marriage' generated a reciprocal reinforcement between cultural homogeneity and resource mobility that combined with greater economic stability. Table 1 shows the results of the presence or absence of one or other of the two spouses:

Table 1 Political authority, culture and the creation of nation states

	Loyalty to a political authority.	*Absence of loyalty to a political authority*
Presence of a single superior culture	(A) First national states (France, Britain)	(B) National unification (Italy, Germany)
Presence of diverse superior cultures	(C) Multicultural national states (Switzerland, Belgium)	(D) Conflict and/or ethnic cleansing (Yugoslavia, Turkey and Greece)

The wedding of groom and bride (case A) led to the formation of the first national states in France and Britain. But Italy and Germany, which pertained to case B—presence of the groom (a recognized superior culture and language) but absence of the bride—had to postpone the marriage until they completed the process of national unification. The opposite situation (case C) of the presence of a groom-state and the absence of a (single) bride-culture is more problematic: it led to dramatic failure in the case of the Austro-Hungarian Empire and has been successful only in some instances (Switzerland and Belgium), also by virtue of multilingualism and federalism. Although case C is a rather rare combination and is not explicitly considered by Gellner, it is particularly interesting (Van Parijs, 2003) because it comprises many of the problems now confronting Europe, where EEC institutions face a very high degree of cultural diversity, and, in many repects, it will be the focus of the next section. Finally, attempts to imitate the classic model of the national state in the absence of both bride and groom have led to violent conflicts and various forms of ethnic cleansing (Yugoslavia, Turkey and Greece are among the most dramatic examples of case D).

Cultural standardization and the creation of a shared national identity are not the only instruments with which national states can counter the risks deriving from the creative destruction intrinsic to capitalist development. The national state has historically relied on a second device as well: the creation of shock absorbers able to neutralize the worst effects of such risks. In Sinn's words (1996, p. 260): 'the government budget is by far the largest risk absorption device available'.

In many cases technology yields high labour productivity only by developing skills that are difficult to transfer to another job (or, in the language of this chapter, are highly *illiquid*). It is customary to distinguish between specificity relative to the firm and specificity relative to the sector. Each of these cases gives rise to problems and solutions with distinctive features (and to different 'types' of capitalism, as the growing body of literature on the varieties of capitalism stresses). In the presence of technologies which require high labour specialization, those who invest in human capital are exposed to serious risks of redundancy if the firm or sector is 'pushed out of the market'. For various reasons, markets are unable to provide insurance against such risks, and this lack of coverage may inhibit investments. In other words, a market failure ensues which may justify public intervention in the form of some kind of social protection.

We therefore interpret the social protection system as an insurance device which provides coverage against otherwise uninsurable shocks that affect investments in specific human capital. This view has too often been neglected in the current political economy debate. It originated with Domar and Musgrave (1944) and has recently been effectively reprised by, amongst others, Barr (1992) and Sinn (1995, 1996). As an insurance device, the welfare state may enable the undertaking of productive investments by risk-averse agents. This point of view is adopted, for example, by Estevez-Abe et al. (2001) and Iversen and Soskice (2001). They explore the nature of the relation between diverse welfare state 'models' and the degree of specificity and intensity of investments in human capital and show that these investments are associated with a higher level of protection, in the form of both employment (employment protection legislation, other institutions providing job security etc.) and unemployment protections.

In other words, the national state encourages agents to invest in human capital both by exploiting the complementarity between cultural homogeneity and economic solidarity, and by using the most suitable combination of these two instruments.[3]

Note that, following this logic, it is possible to identify both a relationship of complementarity between cultural homogeneity and solidarity and one of substitution between the two instruments available to the national state.

On the one hand, if the endogeneity of the degree of cultural diversity is

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[3] It is in this institutional context that firms and other agents are confronted by the residual problems of specificity that require, according to neo-institutionalist theory (Williamson, 1985), costly and complex forms of private governance. In the absence of national macro-institutions, the specificity problems facing private agents would be considerably more onerous. They would require numerous types of guarantees for specific resources which, although they offered locally appropriate solutions, would greatly restrict market mobility. A serious shortcoming of neo-institutionalist theories, therefore, is that they take the macro-institutions that make resources liquid for granted.

recognized, it is possible to appreciate the influence exerted by mutual solidarity policies on the degree of cultural homogeneity. Such policies may lead to the sharing of particular values, and they may reduce the cultural diversity that in agrarian societies frequently marked—often ostentatiously—social differences. Economic solidarity, therefore, is not only influenced by the degree of cultural homogeneity, it is also complementary to it.

On the other hand, it should be clear that policies aimed at increasing cultural standardization and social protection give rise to increasing marginal costs: cultural standardization entails decreasing returns because, as languages, codes and rules are standardized, the cost of losing characteristics specifically useful in particular contexts increasingly outweighs the advantages accruing from their versatility[4]; the extension of social protection creates increasing problems of reduced incentives (the standard moral hazard effect) that, above a certain level, may exceed the advantages deriving from risk reduction. It is therefore possible, with relatively bland hypotheses, to construct a simple formal model where the two instruments are substitute, i.e. where the optimal level of social protection is a decreasing function of the level of cultural homogeneity reached by a certain collectivity (D'Antoni and Pagano, 2001). Because both of these devices serve the same purpose—that of reducing the risks connected with the development of the capitalist economy—the more intense use of one of them reduces the need to resort to the other.

We would point out that, whereas most of the literature surveyed in the previous section drew the conclusion that the 'optimal' level of economic solidarity is an increasing function of the level of homogeneity because homogeneity makes solidarity less costly in terms of consensus, our interpretation leads to the opposite conclusion.

The optimal mix between social protection and standardization depends on the specific costs that each of these two policies produces in a given community. The

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[4] The less specific a skill or characteristic, i.e. the more liquid it is, the less productive it will be in its best use. By standardising languages, codes and rules, we make them less tailored to each specific context. Hence, there is clearly a limit to standardisation.

determinants of these costs are, for example, the initial degree of heterogeneity and the costs entailed by the generalized acceptance of common standards (cultural, linguistic, legal).

4. Beyond the limits of nation-states: the European Union and globalization

Traditional national states have been able to make the best use of both complementarity and substitution relationships between social protection and economic homogeneity. The spread of a single culture has stimulated a sense of economic solidarity and consensus for adequate social protection, and these in their turn have enhanced the cultural integration of the population. At the same time, the national state can choose the best combination between cultural homogeneity and social protection in order to insure its citizens against the risks of specialization in a changeable market society, thereby leaving the private sphere to deal with a relatively minor problem of insurance against the risks of specificity.

In our view, the recent institutional evolution has given the European Union the difficult task of recasting the mix of cultural homogeneity and social protection in a context where the adoption of appropriate social protection policies is particularly problematic.

While nation-states have played a fundamental role in the creation of relatively 'liquid' resources characteristic of markets, the mechanism of reciprocal reinforcement between cultural standardization and market mobility does not restrict the force of its dynamic to within national states. The latter, with their narrow boundaries, transform themselves into impediments against the markets whose development they initially fostered.

Some countries (particularly the United States with its frontier in first real and then symbolic movement) display the advantages of broader aggregations, and they seem to have developed a sense of 'global mission'. Their economic power induces them to extend their language and culture well beyond their national boundaries. The other countries undergo this process of cultural standardization, which they had previously carried forward within their boundaries. Because of the different capacities to exploit the opportunities of globalization, their citizens divide between ‘provincials’ and ‘cosmopolitans’ and the mix between social protection and the liquidity of the skills which guarantee people’s incomes become controversial. The ‘provincials’ feel that the increasingly restricted liquidity offered by the market defined by the national culture makes them vulnerable, and they would willingly replace it with greater social protection. The ‘cosmopolitans’, who have considerably more liquidity, are instead concerned to reduce the costs of social protection, since they do not need its benefits.

Globalization has introduced contradictory pressures. On the one hand, because the opening up of markets increases the mobility of tax bases (primarily capital income), it also increases the costs of redistribution, and therefore jeopardises the sustainability of a welfare state of European type. On the other hand, open economies of small size are those that benefit most from a developed social protection system able to counter the risks due to imported shocks.

It can be argued that, by reducing the costs of mobility, the increasing standardization introduced by the European Community institutions provides a safety valve for regional shocks, with the consequence that it is less necessary to resort to social protection devices.

However, it is possible to show (Arachi and D’Antoni, 2004) that this conclusion is incorrect in a context where, despite the formal elimination of barriers among states, the mobility of individuals is still greatly restricted (for example, by a persistently high level of cultural, linguistic, etc. heterogeneity).

In the presence of limited labour mobility, economic integration (specifically, the growing integration of capital markets, which enables firms to respond to globalization by ‘relocating’ production) may in fact increase the riskiness of investments in human capital. In other words, the asymmetric integration of production factor markets distinctive of continental Europe, where the mobility costs for labour are very high compared, for example with the USA, reduces the risks for firms, but increases those borne by less mobile human capital. The result is an inefficiently low level of investment in specific human capital, and the need to fall back on skills which are more liquid and generic but in many cases less qualified. In this context, social protection functions as a corrective which restores an adequate level of profitability to investments in specific human capital, and this increases the productivity of the system. The benefits of social protection are therefore enhanced by greater international integration.

It is indeed true that the costs of social protection are increased by capital mobility, because in a context of integration the costs of the taxation weighing upon labour are difficult to shift to capital. However, if the former effect (increased benefits from protection) prevails over the latter (increased costs of protection), the optimal level of protection will be an increasing function of the degree of economic integration.

Another important issue is production diversification within each country. Countering sectoral shocks by means of redistribution requires production to be sufficiently diversified. In a world where economic integration is proceeding enormously more rapidly than political integration, the number of sectors present in a single country tends to diminish. Each country tends to specialize in the sectors where it has comparative advantages over other countries. This comes about not only via the resources considered by the standard theory of comparative advantage but also via the comparative institutional advantages that characterize countries (Hall and Soskice, 2001)[5].

Because the absence of political integration rules out the 'first best' solutions of reciprocal insurance among individual countries (that is, a utopian International Welfare State), optimal productive specialization should be pushed to the point

[5] Comparative institutional advantage differs from standard comparative advantage because it depends on the specific merits of the institutions a certain nation (in comparison to another) which may favour the advantageous specialization in certain sector (instead than in another sector). A consequence of comparative institutional advantage is that increasing economic integration may increase institutional diversity because each country specializes in those sectors where it has a comparative institutional advantage - a tendency that may be (partially) offset by other characteristics of globalization (see Pagano 2007).

where the ‘gains from trade’ that it yields are greater than the risks of restricting the number of productive sectors, in terms of the countries’ higher vulnerability to sectoral shocks[6]. However, while the citizens of a country privately appropriate the benefits of specialization, reciprocal insurance among productive sectors is a public good subject to the classic problem of free-riding (Bowles and Pagano, 2006). In the absence of first-best solutions, national states must choose between two difficult alternatives. The lack of public intervention, in fact, gives rise to an inordinately high level of risk due to the excessive reduction of the number of productive sectors in each country. Instead, a public policy designed to curb a country’s productive specialization is difficult to implement, and it is likely to prompt ‘rent-seeking’ behaviour by firms, which apply a pressure to survive well above the threshold constituted by their usefulness for reciprocal insurance among sectors.

Although in principle ‘federal’ aggregations of states may provide a way out of these dilemmas, absent a strong political authority it is difficult that such aggregations could exploit the relationships of complementarity and substitution between social protection and cultural homogeneity in a manner resembling what happened in traditional nation-states.

Considered as a whole, the United States and the European Union differ from the traditional national states in two main ways.

The USA was the first aggregation to demonstrate the advantages of more extensive markets in which all resources (primarily labour) increase their liquidity and their value. Unlike the traditional national states, however, the USA is characterized by a combination of resources liquidity and social protection that is substantially weighted in favour of the former. While the breadth of the market and a homogeneous cultural and legal space have considerably increased the liquidity of resources, the stratification of ethnic groups due to successive waves of immigration

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[6] It is assumed here that the shocks affect asymmetrically different sectors of the economy, so that for a single country having a larger portfolio of sectors means having better opportunities to pool risks by a suitable redistribution mechanism.

have restricted economic solidarity and the possibility of adequate investments in social protection. In a certain sense, in contrast to the traditional national states, the USA has replaced social protection with extensive cultural standardization.

Europe, considered as a whole, is the polar opposite of the United States. Greater social solidarity within individual states (the majority of which were originally traditional nation-states) combines with marked linguistic and cultural diversity among them. The integration process makes the social protection provided by the national states of the European Union increasingly less effective (and a European welfare state is at the moment a politically difficult alternative). Yet Europe cannot count, as the United States can, on a high liquidity of resources (because of the great cultural and linguistic diversity of the EU member-states). The forceful introduction of legislative and cultural standardization, accompanied by limitations on social protection, is a very costly policy in Europe, and it may bring about increasingly fierce reactions against the project for European integration. Although the spread of English, the Erasmus student exchange programmes, the 'Bologna process', and many other initiatives have been useful in shaping a single European culture, it should not be forgotten that the multiplicity of European languages and traditions is widely viewed as an asset which should not be sacrificed for the sake of mobility and the market.

The traditional national states, mainly because their educational systems were based on national syllabuses, were able to reduce to a great extent both 'horizontal' cultural differences among different geographical areas and 'vertical' ones among ethnic groups and social classes in the same geographical area.

If the traditional national state is depicted as case (1) in Table II, the United States can be represented as case (2), where strong horizontal cultural homogeneity among the country's various states and regions is no longer matched by the vertical homogeneity that was once an important feature of the traditional national states. In almost every region of the USA, in fact, ethnic groups are vertically divided into a hierarchy ranging from WASPs to Hispanics down to Blacks. The country has a considerable capacity for solidarity which leads to redistribution among its various regions (e.g. consider the hurricanes which hit areas of the southern United States). However, this solidarity is severely limited when, as in the case of New Orleans, horizontal differences coincide with vertical ones among areas inhabited by whites and blacks. It is therefore no accident that the guarantees covering American citizens against job losses and other hazards of market societies consist more in the liquidity of their investments in human capital than in forms of social protection. In fact, homogeneity among states and the redistribution mechanisms operating among them make the region of the country in which one lives largely irrelevant, whereas ethnic differentiation—also due to relatively recent immigration—makes adequate social protection difficult to guarantee.

The European Union differs from the traditional national state in a manner which is the reverse of the United States, and can be represented by the combination of horizontal differentiation and vertical homogeneity (case (3) in Table 2). Internally, the EU member-states—which were previously traditional national states—are vertically more homogeneous than the United States, but precisely for this reason are horizontally more differentiated. As a result, while redistributive policies are (still) possible within individual EU member-states, redistribution among them is minimal compared with the United States. Increasing immigration from the poorer countries of the European Union, and high levels of immigration from non-EU countries, may sooner or later lead some countries of the Union to case (4) in Table 2, where both the conditions which characterized the traditional national states are lacking. In this situation, ‘more cosmopolitan’ citizens may regard the greater opportunities offered by the European Union as sufficient compensation for the slackening of social protection. But ‘more provincial’ citizens may suffer from both the increased competition due to immigration and from the gradual disintegration of social cohesion policies. And both categories of citizens may under invest in human capital in so far as, unlike the traditional National States, the European Union is unable to a achieve a reasonable mix between cultural standardization and social solidarity.

Table 2 Vertical and horizontal cultural homogeneity and differentiation

	Vertical cultural homogeneity	*Vertical cultural differentiation*
Horizontal cultural homogeneity	(1) Social and regional solidarity (*traditional national states*)	(2) Regional solidarity without social solidarity (*United States*)
Horizontal cultural differentiation	(3) Social solidarity without regional solidarity (*Europe*)	(4) Absence of social and regional solidarity (*The future of Europe?)*

To summarize: Europe differs from the United States in that it is unable to substitute (except to a minimal extent) social protection with the increased liquidity of human resources. Europe as a whole is therefore necessarily in need of a higher level of protection. However, the complementarity and substitution relations between cultural homogeneity and social protection imply that Europe is now in the paradoxical situation where forms of European social protection are extremely difficult for the same reason that they are so necessary. The absence of cultural homogeneity hampers the introduction of the social protection policies that, in Europe, are necessary precisely because of cultural diversity and the consequent illiquidity of many human resources. In Europe, the complementarity between economic solidarity and cultural homogeneity makes it impossible to achieve their satisfactory combination.

If Europe's current problem is viewed as an imbalance in the mix of social protection and cultural standardization provided by the European Community institutions, it is possible to account for the apparent paradox of the French referendum on the European Constitution, where the latter was accused of being both too courageous and too timid. For some, the Constitution was excessive because it called for acceleration of the standardization process; for others it was insufficient because it did not combine standardization with adequate social protection policies. In effect, therefore, these were two sides of the same dilemma.

5. Two views of federalism

According to Abba Lerner (1972, p. 259) the relation between economics and politics could be framed in the following way:

> An economic transaction is a solved political problem. Economics has gained the title of queen of the social sciences by choosing *solved* political problems as its domain.

Years before, as it grew increasingly evident that international political problems would lead to war, Lionel Robbins (1937)—while emphasising the merits of economic science—made the shortcomings of this approach very clear. He did so in an essay which, through the good offices of Luigi Einaudi, reached and influenced Altiero Spinelli and Ernesto Rossi in their confinement on the island of Ventotene. Referring to the tradition of Smith and Bentham, Robbins (p. 50) wrote that ‘in their preoccupation with the discovery of the laws of the market, they were apt to take the market itself for granted’.

Whilst it was true—Robbins contended—that economic transactions could resolve certain economic problems, it was the task of politics to create the conditions that made those transactions possible, and to develop certain complex institutions such as markets. The two perspectives on cultural diversity and economic relation we have discussed at length in the previous sections of this paper can be seen as corresponding to the different views of Lerner and Robbins on the relation between market and politics.

The federalist movement, initiated in England by Beveridge and Robbins and then developed by Spinelli and Rossi, had precisely the aim of creating the political conditions in which international—and primarily European—markets could operate.

Conversely, the model of federalism that emerges from large part of economic studies on the relationship among heterogeneity, the structuring of the levels of government, and public policies, belongs to the tradition that, since Adam Smith, has regarded competition and the elimination of monopolies as the best way to increase social well-being. Decentralization of the state's powers and their reciprocal competition in a setting where factor mobility can be obtained simply by removing monopolistic barriers have been viewed as devices to improve efficiency.

Competition may be an ingenious solution for the problem of heterogeneous preferences in the provision of public goods. This conclusion is synthesised in the 'Tiebout conjecture' which, notwithstanding the abstractness of its assumptions, suggests that combining the multiplicity of the jurisdictions with the mobility of the individuals may attenuate the problems caused by heterogeneity by encouraging individuals to cluster into culturally homogeneous units. When the existence of a large number of jurisdictions is reconciled with the need to guarantee sufficient economies of scale for states, transactions among states and individuals enable the latter to cluster according to their preferences and ethnic-cultural characteristics (Alesina and Spolaore 1997). In each state or jurisdiction, the higher degree of homogeneity among individuals allows each of them to benefit in the best way from the particular public goods that they desire. Thus we have a typical success by the 'queen of the social sciences': 'economic transactions' generate 'solved political problems'. If the economies of scale were not important, so that having large states would be of little use, the 'supply' of states would be rich enough in number and diversification to make democratic decisions within states largely useless: competition, in fact, would be the best guarantee for the citizen-consumer.

There is no doubt that this mechanism might prove useful (perhaps in a less extreme form) for some of the dimensions of heterogeneity examined in Section 2. But the problem still remains that the low (virtually zero) costs of mobility assumed in Tiebout-like models (such as Alesina and Spolaore, 1997) presuppose that for a good number of those dimensions homogeneity has been achieved which enables individuals to cluster together according to other, heterogeneous characteristics. It will be possible, for example, to move at low cost to states with the desired mix of taxes and public goods if there exist a language, an occupational structure, and an educational system similar to those in the state of origin. It is not usually recognized that it is homogeneity along some characteristics which enables people to cluster in jurisdictions that are heterogeneous in other characteristics. This twofold nature of federalism induces emphasis to be placed on the 'Smithian' aspect when these homogeneous characteristics can be taken for granted, but it shifts the emphasis to a problem that we may call 'Hobbesian' where at issue is the construction of common ground among diverse states with often conflicting interests.

Smithian federalism is typical of political aggregations with strongly homogeneous national identities which decentralize some functions to peripheral units. Individuals may freely move among states, either because one of the latter (which is now the federal state) has created a strong common identity which makes the cultural identities of the individual states belonging to the federation largely irrelevant (for example, the German Federal Republic), or because the individual states and the federal state have developed *pari passu* (for example, the United States of America). The Hobbesian problem of limiting the sovereignty of the peripheral units in order to ensure the emergence and development of common characteristics has, in this case, been already solved by the prior existence of a national state (which has changed into a federal authority) or by the synchronous development of peripheral and federal authorities.

The roots of European federalism are instead markedly Hobbesian, and they date back to the tragic events of the two world wars. From their confinement on the island of Ventotene, Altiero Spinelli and Ernesto Rossi criticised those who wanted simply to restore the European democratic regimes on conclusion of the war with no endeavour to forge a federative pact among them:

> Whereas at national level, the intelligent restorationist realizes that it is not possible to rely simply on the good will of citizens, but that it is necessary instead to establish a solid body of laws backed by coercive power in order to curb and direct individual activities, relationships among states are still based entirely on the good and peaceable will of each them, the assumption being that the interest of an individual state

> entirely coincides with the interest of all states (Spinelli and Rossi 1944, p. 36).

As Norberto Bobbio (2004, p. XXXV) has pointed out, the federalist view takes Hobbes as one of its referents. It extends the reason that induced Hobbes to wish for the birth of the state to the level of the international order, and it arose when, during the Second World War.

> [I]n the minds of some, the central idea gained ground that the essential contradiction responsible for the crisis, war, misery and exploitation afflicting our societies is the existence of sovereign states, geographically, economically and militarily isolated, considered by the other states to be competitors and potential enemies, and each living with respect to the others in a state of *bellum omnium contra omnes* (Spinelli and Rossi 1944, pp. 3-4[7]).

This view recognizes the fact that 'the equal right of all nations to organize themselves into independent states' has in the end brought about a grave 'crisis of modern civilization'.[8] The problem of federalism therefore becomes that of restricting the sovereignty of national states while at the same time constructing a common cultural identity that partly replaces the well-established identities of individual states. The role of the federal state—the cultural and legislative homogeneity and inter-state economic solidarity which Smithian federalism of the US assumes as its point of departure—has become the crucial problem of European federalism. In this case, the problem has not been that of fostering Smithian competition among states, but rather of restricting Hobbesian competition among

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[7] This passage, which is part of the preface, was in fact written by Eugenio Colorni and undersigned 'Il Movimento Italiano per la Federazione Europea'.

[8] Spinelli and Rossi (1944, p. 9). Spinelli and Rossi were well aware of the fact that 'the ideology of national independence has been a powerful factor for progress'; 'it has enabled paltry provincialism to be overcome' and it 'has eliminated many of the obstacles that circulated/impeded the circulation of people and goods'.

political units with the strongly-defined cultural identities that led to two world wars.

Although European integration has brought increasing benefits of Smithian type, the central problem is still that of identifying institutions which allow a closely integrated common market to operate efficiently—and in particular the institutions that ensured the existence of a common culture and sufficient economic solidarity within the national states that are now members of the European Union.

We believe that Europe must firstly engender a dynamic of reciprocal reinforcement between moderate cultural and linguistic standardization and moderate mobility that does not excessively erode regional and national identities. Secondly, Europe must introduce forms of redistribution among the European countries that will naturally complement the increasing specialization of states, but at the same time do not impede the formation of a sense of European solidarity. Finally, in Europe the national welfare states must protect their citizens in a situation where the enlargement of markets, because they involve the productive factors asymmetrically, do not provide adequate protection, but on the contrary seemingly increase the risks of investment in human capital. All the items of this challenging agenda raise delicate Hobbesian problems of (moderate) transfers of sovereignty from the national states to the European Union. If they are successfully resolved, we may one day be able to say that some ‘solved political problems’ have generated numerous and beneficial ‘economic transactions’.

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