Nation states vs. united empire:  
Effects of political competition on economic growth

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Abstract  Is political fragmentation, i.e., nation states, more favorable to economic growth than political unification, i.e., a united empire? This study develops an endogenous-growth model to analyze the growth effects of fragmentation versus unification. Under unification, the economy is vulnerable to excessive Leviathan taxation and possibly subject to the costs of unifying heterogeneous populations. Under fragmentation, the competing rulers are constrained in taxation but spend excessively on military defense. If capital mobility is above (below) a threshold, then fragmentation (unification) would favor growth, and this threshold is increasing in the degree of defense competition and decreasing in the costs of heterogeneity.

Keywords Economic growth · Leviathan taxation · Interstate competition · Political fragmentation

JEL Classification H20 · H56 · O41 · O43

1 Introduction

Is political fragmentation, i.e., nation states, more favorable to economic growth than political unification, i.e., a united empire? A number of economic historians, such as North (1981) and Jones (1981), argue that the unique European nation-state system contributed to its economic takeoff in the late eighteenth and early nineteenth century while the united-empire system then extant in China was responsible for its economic stagnation during that period.¹ For example, North (1981) suggests that interstate competition arising from political fragmentation induces the competing rulers to recognize private property rights in order

¹See, for example, Bernholz et al. (1998) and Bernholz and Vaubel (2004) for a comprehensive survey.
to prevent labor and capital outflows, and the resulting economic system with secured property rights creates the conducive environment for capital accumulation and growth. However, Bernholz and Vaubel (2004) note that political fragmentation did not always lead to such predicted effects.

Political fragmentation is not a sufficient condition for political competition, innovation, and growth. [...] Political fragmentation will not lead to interstate competition unless there is considerable mobility among jurisdictions. [...] Political fragmentation will not favor innovation and growth if it leads to prolonged and highly destructive wars rather than limited warfare or peaceful competition for manpower and capital. (Bernholz and Vaubel 2004: 14–15)

The present study explores the following questions in light of these perspectives. Firstly, under what conditions would fragmentation be more favorable to growth than unification? Secondly, when a political regime is decided upon by rulers, do they have an incentive to choose a regime that favors economic growth?

This study analyzes the different growth effects of political fragmentation versus unification by developing a simple endogenous-growth model characterized by three parameters indexing (a) the degree of capital mobility, (b) the extent of competition in military defense, and (c) the costs of heterogeneity or the benefits of unification under a unified country. We analyze how these three factors affect households’ capital-investment rate and their rulers’ chosen tax rate, which in turn determine the equilibrium growth rate, under the two political regimes. We follow Karayalcin (2008) in using the tax rate to capture both legal and extra-legal property expropriations by rulers. This formulation of using taxation as a measure of property rights is also consistent with Drazen’s (2000, p. 459) observation that “...property rights can be considered in the narrow sense as applying to taxation of property: even in the absence of the threat of outright expropriation, societies can nonetheless legally expropriate the fruits of accumulation via taxation.”

Within this framework, we have the following findings. On one hand, political fragmentation can be advantageous to growth because competition between rulers limits their ability in taxing households. The extent of this limitation is governed by the degree of capital mobility, which in turn is determined by the cost of allocating capital abroad. This cost is meant to capture North’s (1981) idea that the monopoly power of a ruler depends on the citizens’ cost of exit. On the other hand, political fragmentation can be damaging to growth if competing rulers allocate an excessive amount of productive resources to military defense. As for the case of political unification, a unified country may have (a) a higher level of aggregate productivity due to economies of scales and lower trade barriers or (b) lower productivity due to the costs of unifying heterogeneous populations into a single nation. We will consider both possibilities. Allowing for the costs of heterogeneity enables the model to capture some of the important insights from the country-formation literature. For example, Alesina and Spolaore (2003, 2005) argue that there are additional costs in ruling heterogeneous populations under a single nation. Potential sources of these costs include conflicting preferences over public policies, coordination costs, monitoring costs, and expected losses associated with civil wars.

In summary, under unification, an economy is vulnerable to excessive Leviathan taxation and subject to the costs of heterogeneity or the benefits of unification. Under fragmentation, competing rulers are constrained in taxation but they spend excessively on military defense. The theoretical analysis suggests that whether fragmentation or unification is more favorable to growth depends on the degree of capital mobility. If the degree of capital mobility is above (below) a critical threshold, then fragmentation (unification) would favor growth. Also, this