RUSSIAN FEDERALISM: ECONOMIC REFORM AND POLITICAL BEHAVIOR

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Abstract

This paper explores the implications of Russian federalism of the "new" interregional economic inequality produced by the structural distortions inherited from the central planning, and immaturity of the Russian markets. As a result, regional preferences over federal policies are widely diverse, which makes a nation-wide consensus hard to reach. It is argued in the paper that high correlation between political and regional divides in Russia renders the federation unstable and that the instability, in its turn, reproduces interregional disparities. These links are also illustrated by a simple equilibrium model presented in the Appendix.

When the federal legislative bodies are "uprooted", captured by extra-territorial narrowly based interest groups, and lose their accountability to the voters, regional administrations emerge as representatives of their jurisdictions on the federal scene, and decision-making at the federal level assumes the form of federal-provincial bargaining. Such bargaining entails vast efficiency losses, since the federal administration is pressed to spend its resources for buying compliance of regional counterparts, instead of providing mandated public goods. It is stated in conclusion, that until markets integrate Russian regions and hence locally based political interests, the country will be failing to develop "market-preserving federalism" (Weingast, 1995), i.e. a federal system which stimulates economic growth and imposes self-enforcing restrictions on counterproductive discretion of public officials.
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1 Federalism and transition

Several years ago the architects of the Russian reform thought that they had a simple way to untangle the know of intertwined social, political and economic problems of transition of a market democracy. The chosen strategy provided for sweeping economic liberalization and withdrawals of the state from the economy to the maximal possible extent. It was expected that broad social support for the reform would be sufficient to get through the hardship and dislocations of the early stage of transition, and that in the meantime efficiency gains produced by free market would start trickling down and create a sustainable social base for the new economic order.

Implemented simultaneously, political reform was supposed to lay the foundations for a liberal democracy in Russia. While safeguarding private property, economics freedoms and other cornerstones of a market economy, new political institutions should have provided for publicly accountable governance driven by needs and interests of emerging civil society in Russia. That would have been a dramatic departure from Russia’s historical tradition, where for centuries the state was the initiator and key agent of economic and political change.

It was commonly accepted that, given the size and diversity of the country, a political system capable of reversing the above trend couldn’t be but a federation. Standard economic and administrative rationales for a federal state in Russia were reinforced by the strong liberal appeal of federalism, and the resentment of past overcentralization, with its bureaucratic mismanagement and callousness.

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In reality, separation of political and economic reforms has proven to be impossible. Tensions and contradictions of profound economic changes in Russia permeate the country's political life, and politics sends powerful feedback to the economy. Strong interdependence of political and economic processes dramatically affect incentives and opportunities of market agents and political forces.

Russian federalism is a major focal point of such interdependence. Instead of serving, according to its ultimate purpose, as a way to accommodate diverse economic and political interests, federalism in Russia feeds conflicts and exacerbates the tensions and uncertainties of transition. Contention, rather than reconciliation, seems to be a generic feature of post-communist federal states, and the strife it breeds threatens these states' very existence. Russia so far has managed to preserve its territorial integrity, whereas all other formerly communist federations - the USSR, Czechoslovakia, and the former Yugoslavia - have disappeared from the map.

While profound ethnic dissimilarities and unwieldy political systems are certainly among the major causes of these cataclysms, economic factors seem to have been equally potent. In Russia, with 85 per cent of population belonging to the titular nationality and sharing strong feeling of ethnic identity, multi-ethnicity alone would have not been able to feed the current strains in federal-provincial relationships. Moreover, the unified standards of education, social and economic life that prevailed in the former Soviet Union, have produced a highly homogeneous society (at least with regard to its numerically predominant urban part), with a weakened sense of affiliation to a particular region. "Being deprived of the "small motherland" ... and often even of non-Russian ethnic self-identification, a Russian citizen feels himself a part of nothing less than Russia itself" (Naishul, 1996). Likewise, notorious imperfections and mismatches of the Russian constitutional framework could have been corrected in an orderly fashion if key political players and forces in the country were united in their will to streamline the political environment to everybody's benefit.

This paper argues that the problems of Russian federalism to a large extent should be ascribed to the deep inequality of economic opportunities in different parts of the country, to the segmentation of the Russian markets, and to a few other features of the Russian economy that are either inherited from central planning or produced by recent changes of economic and political institutions.
2. Economic reform and "new" interregional inequality

Interregional economic inequality has always been a fundamental feature of the Russian economy and society. Central planning, despite its ostensibly egalitarian emphasis and the system of administrative transfer of resources between the regions, failed to eliminate spatial economic inequity. The considerable interregional disparity in living conditions prevailed as a result of failures of the distribution system and/or biases of the ruling elite in charge of allocation of resources for private and public consumption.

After the command economy had been abandoned, the "old" interregional inequality described above has ceded to the "new" one, based on unequal opportunities to adjust to evolving economic conditions. The "new" inequality is brought to existence by the interaction of market forces with lasting legacies of the central planning.

Non-market principles of industrial location that dominated in Russia over seven decades have produced spatial economic profiles that are inconsistent with market demand and non-sustainable in a free-market environment. Artificial locational decisions stimulated migration and occupational choice which are also in mismatch with market needs and opportunities. As a result, ability to generate market income, low as it is Russia-wide, differs dramatically from one region to another.

Structural changes in the Russian economy are driven by three major factors - suppressed domestic demand and heavy reliance on international trade, non-competitiveness of the Russian manufacturing firms, and collapse of the former backbone of the Russian economy - its military-industrial complex (see e.g. Sutherland, Hanson, 1996). As a result, regions that feature export orientation (with economies based on natural resources, metallurgy and chemical industries) and/or serve as hubs of international trade and finance, have been able to adjust to the new realities and even gain from the recent changes. As opposed to these "extroverted regions", the rest are "introverted", with local economies dominated by military enterprises and manufacturing firms (OECD Economic Survey, 1995). Introverted regions are almost without exception on the losing side. Opportunities for export and international trade are distributed unevenly and concentrated in a few areas (sparsely populated North and East of the country, major ports, and the capitals - Moscow and St. Petersburg). Elsewhere regional economies are heavily hit by contraction of domestic demand and superiority of imports over local production. These areas feature low earning abilities of the population and are well behind the national average in terms of employment and household incomes (Illarionov, Layard, Orszag, 1995).
The impact of severe economic shocks was not compensated by commensurable subsidies and transfers from the federal budget to adversely affected regions. To begin with, such transfers are difficult to fund during the transitional fiscal crisis and attempted financial stabilization. Besides, the chosen blueprints of reform did not envisage for the state an active role in the process of economic adaptation and structural adjustment. Such adjustment was supposed to be driven primarily by private initiative. From this perspective, broad-scale federal assistance to the crisis areas would have been counterproductive as suppressing market signals and incentives and preserving inefficient economic structure.

However, interregional economic inequality plays a positive role only if there are opportunities to respond to market stimulus in a productive way. That requires sufficient social and economic mobility, availability or ways and means to move out of poverty and depression. Under these conditions even high interregional inequality is tolerated, as it is being released while producing efficiency gains and without breeding social conflicts. On the contrary, if the above adjustment opportunities are foreclosed, inequality is tolerated within a much narrower range. Beyond that range, it prompts seeking a redress by extra-market means, and "bubbles up" in politics.

Economic mobility is based on a functional labor market, which in its turn requires a developed real estate market and universally available public services and social safety nets. None of these requirements are met in Russia. Industrial firms still have not been divested of responsibilities to support social infrastructure, and unemployment insurance benefits are paltry and poorly administered. As a result, quitting a job entails high risk and could put an individual in a social and economic limbo. The real estate market is suppressed by obscure property rights on land, and unavailability of affordable mortgages. The cost of housing should be paid upfront, which effectively prohibits migration from a depressed area into a relatively prosperous one. Besides, local governments (for the reasons specified below) erect administrative barriers to the movement of population into the region.

As a result, spatial disproportions of population and labor are sustained. Overall, "the Russian labor market remains characterized by low interregional labor mobility, significant inefficiencies in labor allocation, and a large employment overhang" (Commander, McHale, Yemtsov, 1995).

In theory, insufficient mobility of population and labor could be compensated by investments which create new jobs in depressed regions. It is well known, however, that economies of agglomeration and scale, transportation cost, availability of knowledge and skills, the increased importance of legal and political considerations could prevent movement of capital into crisis areas. And indeed, in 1995 the city of Moscow - an oasis of relative economic prosperity in the
crisis-stricken country, received 57% of all foreign investments flowing into Russia (OMRI Daily Digest, 6 February, 1996; see also Sutherland, Hanson, 1996). Worse yet, the common obstacles to interregional economic parity are greatly exacerbated in Russia by the suppressed capital market and the virtual collapse of domestic industrial investments. The capital market and investments are stifled by inadequate protection of property rights, poor enforceability of contracts, profoundly asymmetric information, low liquidity constraining upcoming entrepreneurs, overall political and economic instability, and until recently - high inflation.

In the absence of fully functional input markets spontaneous economic adjustment, which according to the blueprints of the Russian reform was supposed to correct structural distortions of the Russian economy, further deepens the interregional economic cleavage. Indeed, new economic opportunities appear in Russia mainly in services, trade and finance. Trade and services, whose share in the Russian GDP has risen over the last few years from 1/3 to 1/2, are driven primarily by local demand, and therefore tend to be concentrated in the regions where the economic situation is already more favorable. This is a general phenomenon: in all states of Central and Eastern Europe unemployment in capital cities is at least twice (if not several times) as low as national averages (Milanovic, 1995). Large non-capital cities and metropolitan areas, while lagging behind (sometimes dramatically) Moscow and Sankt-Petersburg, in their turn offer significantly broader adjustment opportunities for the local population, than small towns and the countryside, and their lead is further enhanced by the "structural multiplier" described above. As a result regions with high concentration of population quite often outperform those featuring mainly small towns and villages.

Relative prosperity in more fortunate regions not only expands earning opportunities, but also feeds local budgets, so that higher personal incomes are combined with better public services. Another "inequality multiplier" is in price discrimination against the depressed regions, as narrow local markets are easier to monopolize. Absence of economy of scale in trade works to the same end, keeping retail prices higher.

Therefore the benefits of structural changes are distributed across the Russian territory in a highly uneven fashion. While inherited distortions and, to the a lesser extent, the country's geography are the initial causes of the problem, it is sustained by unavailability of fundamental public goods, including institutional foundations of market economy, freedom of movement of labor, capital and commodities across the country, and overall political and financial stability. Without these public goods, the population of depressed regions is economically trapped and subject to triple discrimination: by low incomes, reduced purchasing power, and general inability to find in the new marketplace good use for human resources.
This situation is in sharp contradiction with the new, liberal, concept of fairness, which was offered to Russians in place of the discredited egalitarian interpretation. Deep dissatisfaction in the ability of the old regime to deliver on the official pledges of equal society, and mistrust in the new government made liberal justice, which emphasizes individual freedoms, self-responsibility, and adequate reward of productive labor, a socially attractive alternative, broadly supported at the early stage of the reform throughout the country (see e.g. Gorin, 1995). However, liberal justice rests heavily on unhampered access to non-discriminatory markets which reward everybody who can contribute economically valuable factors of production, including human resources. As these conditions are not met in today's Russia, the new social and economic order has failed to establish a new fairness instead of the old one, and is therefore perceived as altogether unjust.

This unfairness not only threatens social peace and prompts attempts of extra-market redistribution of wealth, but also undermines national unity. The integrity of the state, unless kept by force, rests upon the feeling of being a member of a community where everybody has certain rights, guaranteed and protected by this community. Otherwise those who feel themselves discriminated against would be trying to find an identity with a smaller group which guarantees some fairness to its members. In Russia, where the place of living is one of the main factors of social and economic discrimination, regions become natural candidates on the role of a community which maintains reasonable standards of fairness, unavailable nationwide. The federal structure of the Russian state provides a conducive framework for political ramification of these sentiments, which are originally brought to existence by economic forces.

3. Regional interests and the federal legislature

The Russian federal system provides for accommodation of the regional interests both at the national and subnational levels. Nationally, regions are represented in both houses of the Russian parliament. Subnationally, they have their own jurisdictions - exclusive or shared with the federal government, where regions exercise legislative and administrative autonomy. Russia, therefore, meets at least de jure the basic test of a democratic federation by providing two overlapping principles of representation - through regional and national bodies of power (Riker, 1964, King, 1993).

From an economic perspective, the federal state is a structure designed for a two-level provision of public goods, every such good being assigned to a particular level depending on the geographic area where the good is available, the economy of scale of its provision, opportunities to customize the public good to local needs and preferences, and the presence of interjurisdictional
spillovers (Oates, 1972). It means that subnational governments, in charge of locally available public goods, need to be primarily concerned with their constituencies, rather than being involved in communications with federal authorities. Ideally, local interests should be incorporated into nation-wide decision making not through regional governments, but directly through elections into the federal parliament. Although the experience of modern federations, including Canada, does not fully conform with the above principle, the latter still provides a useful general guideline.

In Russia, however, this principle is completely invalidated: the regional interests, which barely transpire in the Duma, are communicated to the federal level almost exclusively through subnational governments.

The conspicuous absence of regional interests from the agenda of the federal legislature could partly be ascribed to the Russian electoral law which provides for election of half of the Duma through national party lists (Ordeshook, 1995). Another half, however, is elected directly from the regions, and if the Duma still remains indifferent to the interests of local constituencies, it needs to be explained in terms of incentives of the Russian MPs. These incentives, in turn, could easily be traced to the economic situation in the country, and in particular to interregional economic inequality.

First of all, dissimilar economic situations in the regions produce broadly diverse regional interests. Regions with stagnating economies would press for massive governmental subsidies to firms and households - if necessary, at the expense of financial stability. At the same time, resource-rich regions strongly oppose such transfers. Territories dominated by obsolete manufacturing firms would insist on trade protectionism, while exporters vie for free international trade. Such areas also want a cheap ruble, whereas metropolitan centers heavily relying on imports press for quite the opposite. Altogether, as separation lines between beneficiaries and losers of the reform, and, more generally, between conflicting economic interests, all too often coincide with interregional boundaries, constituent units of the Russian federation pull national policy making in sharply different directions.

Russia is by no means special in its political heterogeneity, and such heterogeneity in itself doesn't necessarily threatens stability of a federal state. The success of federal systems is not to

\footnote{According to (Delliagin, 1996), support to export-oriented sectors of the Russian economy has contributed to the dramatic interregional inequality in Russia and threatens the very integrity of the nation. One of the main rationales for the introduction in 1995 of the "currency band" which stabilized the ruble was to reduce the above differentiation. Responding to the pressure of exporters, the policy was later relaxed and tied the exchange rate to the domestic inflation.}
be measured in terms of the elimination of social conflicts but instead in their capacity to regulate and manage such conflicts" (Gagnon, 1993). Russia is distinct, however, in having conflicting political and economic interests based in particular regions, rather than being spread throughout the country. As a result, the national political agenda is not an enlarged replica of those in a majority of regions, and the task of reaching a nation-wide consensus consists in balancing regional interests with each other, not the interests of interregional social and political forces.

When political and regional divides are highly correlated with each other, as it is the case in Russia, a federation becomes unstable, and its decision making capacity restrained. On the contrary, when such correlation is low, a federation could not only be easily sustained, but even brought to existence, despite of its political terrain being separated by high watersheds. What is important is that such watersheds cross interregional borders, not follow them.

For example, in the late XVIIIth century most of the would-be constituent units of the US were East Coast states, geographically "parallel" to each other with similar longitudinal East-West internal divides between agricultural interiors on one side, and trade and industry driven coastal areas - on the other. These conflicts were reflected - and ultimately resolved - on the national level, in the debates between the agrarians and coastal mercantile. The ultimate arrangement, although anything but perfect for the involved parties, did not leave disenfranchised states, and had no negative consequences for the unity of the newly created federation. However, when over half a century later the inequality of economic interests and opportunities, which was earlier confined within states, changed the direction from East-West to North-South and had become an inter-state divide, the country was plunged into a civil war.

Diversity of economic and political agendas in the regions also complicates the creation of political parties with both national and subnational representations. Such parties are expected "to have a binding impact upon the federation. Conversely where there is a notable and resilient 'asymmetry' between the central authorities and the local party elites and organizations the

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2 While some of the nation's political divides, most notably between the cities and the countryside, and between younger and older generations, are exterritorial in their nature, they are often strongly correlated with the interregional division, which partly explains the dichotomy between the "pro-reform North" and "anti-reform South" (McFall, 1996). Besides, regional interests could override those without a regional base. For example, only 9% of Moscow university students voted in the 1995 for the communists, while over 50% supported liberal parties. On the contrary, 30% of students from non-capital cities cast their votes for the communists, and another 20% - for the ultranationalist party of V. Zhirinovsky (Obshchaya Gazeta, n 17, 1996).

3 We owe this example to Peter Ordehook.
resulting differences of interest may have a centrifugal effect" (Burgess, 1993).

If the regions in their entirety are taking sides in national policy conflicts, whatever middle point could be reached will likely leave whole regional constituencies disappointed, as policy measures taken at the federal level will be far from what the region needs. Members of parliament elected from such constituencies, even if they are doing their very best in pressing the interests of their electorates, will produce only marginal changes, if any, and voters back home will have no appreciation of that.

Interregional economic inequality not only diminishes opportunities for regionally elected members of the parliament to satisfy their voters - it also dramatically reduces bargaining power of a majority of these MPs, as they represent depressed areas with little economic resources and wealth. A few economically powerful regions have a much stronger clout over the federal government, which makes the case of their opponents, hard as it is, virtually hopeless.

Under these circumstances, the members of the Russian Duma routinely give up their allegiances to the regional constituencies where they were elected, and start serving more powerful political forces, usually without clear territorial affiliations, which control resources far exceeding those available at the home region. As a result, instead of being a representative body, the Duma becomes "a conglomerate of ... corporate interests. The budget was a compromise of sectoral demands. [In the recent elections] every major corporation had its own party, so 43 electoral blocks and parties shouldn't surprise anybody" (Evgeni Saburov, Segodnia, December 29, 1995). Alongside the old groups of interest (oil and gas, agrarians, military-industrial complex) new powerful forces come into play - banks, industrial concerns, holding companies, financial-industrial groups - to share control of the legislature. Overall, "... the problem of the Russian democracy is the absence of representativeness, [which requires that] a deputy is indeed connected to his voters and represents these voters, instead of the deputy's sponsors - commercial or political" (Mikhail Leontiev, ibid).

Of course, political infidelity hampers the prospects of members of the Duma for re-election. And indeed, while 90% of the members of the old Duma ran in December, 1995 for the second term, incumbents were re-elected only in 65 out of 225 single-member districts. (It is symptomatic that another 28 deputies representing regional districts in the old Duma were elected anew from different territorial constituencies or on political party lists). This re-election ratio is particularly dismal, given the advantages of incumbents, who "are more easily identified by voters, and are

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4 We are thankful to Alexandr Sobyannin for these data.
better experienced in electoral politicking. They have stronger links to federal and local elites, more diverse fund-raising sources and greater access to the mass-media than challengers. However, in Russia these advantages were sometimes disadvantages in the eyes of frustrated and disenfranchised voters who were looking for changes" (Constitution Watch, Russia, 1995).

Termination of a career in the parliament doesn’t constitute as much of a punishment in Russia, as it would have been in a stable and mature democracy. Political and economic uncertainty considerably devalues parliamentary tenure. Given such uncertainty, members of the Duma are prepared to trade their political future for the hefty gains available at present. One term in the Duma is usually enough for a rank-and-file MP to launch a career in the federal bureaucracy or otherwise secure a niche in the Russian political and economic elite. Symptomatically, the vast majority of former deputies of the federal parliament stay in Moscow instead of returning to their home regions. By and large, given the choice between the "Chicago" model where politicians’ main concern is about getting reelected, and the "Virginia" model with politicians seeking instead private rent (Przeworski, 1995), the latter model clearly prevails in the Russian Duma.

As a result, the Duma becomes uprooted and fails to serve as a floor for reconciliation of regional interests and priorities over issues of national policy. This is just one of several possible patterns of malfunctioning representative assembly in a deeply divided society. Another option is mass pork-barrelining, where members of parliament, being unable to influence major policy decisions in the way desired by their constituencies, compensate the latter by various "side payments" in cash and in kind. The examples include Italy, with a "smooth system of lottizzazione or "jobs for the boys", [and India with] successful demands for caste quotas of public jobs and admission in professional schools" (Bardhan, 1993).

In both versions national divides that produce the above patterns of malfunctioning parliamentarism, are sustained, if not enhanced, by feedback political processes. "In India, for example, it is generally agreed that political democracy has considerably strengthened caste divisions" (ibid), as it pays to be clearly identified with a group which is subject to state patronage.

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5 This arrangement is viewed by some in Russia as a second-best option, clearly preferable to the "hung" Duma. Governor of Nizhny Novgorod region B. Nemtsov promised that his evaluation of members of the parliament elected from the region "will be based not on their political declarations, but on the amount of money that the region will receive from the federal budget" (Segodnia, December 28, 1995).
As for the Russian case, indifference of the federal bodies of power to the needs of local constituencies is fraught of massive protest vote which further breeds political instability. Disappearance of the political "center" produces "revolutionary, polarized politics" (McFaul, 1996) fraught of not just moderate policy corrections, but complete overhaul of fundamental economic and political institutions. As a result, the efforts of the incumbent reformist government to establish the institutional framework of a market economy are not viewed as credible. That further stifles restructuring and, in particular, industrial investments, needed to spread across the country the opportunities to earn market income.

In other words, economic disparity and political uncertainty which are both responsible for the failure to accommodate the interests of Russian regions through the federal political institutions, are linked in a vicious circle. "Consensus is more difficult to reach when there is substantial divergence in policy preferences, and critical laws ... are simply not passed, or are subject to continual cycling in the uncovered set. ... Inequality creates greater uncertainty regarding policy outcomes" (Keefer, Knack, 1995). Uncertainty, in its turn, reproduces institutional void, which threatens property rights, puts barriers to investments and labor mobility, deadlocks development of new social services and safety nets. That makes interregional inequality chronic. (A simple equilibrium model illustrating this conclusion is presented in the Appendix.)

4. Regional administrations: a takeover

Capture of the Duma by extra-territorial political forces leaves a vacuum in representation of regional interests on the federal scene. The only political institutions in Russia capable of filling this vacuum are regional administrations, which have taken over the functions of federal-provincial political communications almost in their entirety. This "takeover" goes well beyond the primary purpose of subnational governments in a federal state, consisting in providing public services assigned to regional jurisdictions.

Regional administrations have dramatically expanded their role in the last few years, as the central governments - initially of the Soviet Union, and later of the Russian Federation, were progressively losing their control over the economy, political and economic life. This process was particularly accelerated when the government of Russia gave up its previously held responsibilities in providing basic social services and maintaining living standards of the population.

That move, prompted by the idea that the federal government was unable to perform these functions anyway due to administrative and financial reasons, had produced a huge void in the
Russian public sector and resource allocation. It was expected that this void should be filled either by market forces or newly grown systems of provision of public goods and social services, consistent with a market economy and burdening the federal authorities to the least possible extent. The same philosophy, already mentioned earlier in the paper - to clean ground for spontaneous growth of new economic and political institutions, with market incentives, economic rationality and common sense at work and unimpeded by inept bureaucracy - dominated throughout the spectrum of economic and political reform launched in 1992. The approach was also expected to contribute to political stability, as dramatic reduction of the domain of public decision making should have channeled transitional conflicts and contradictions to the politically non-charged marketplace.

Unfortunately, on more than one important occasion this tactic has produced results far from those expected. While the classical evolutionary theories of institutional change indeed imply that superior institutions will spontaneously emerge from the grass roots, this is not the only possible path of development. In Russia the process went a different way, with distributional conflict dominating evolutionary learning and selection (Knight, 1992).

In particular, the vacancies left by the federal authorities for the market were instead promptly filled by regional administrations. While being primarily driven by the desire of the pre-reform regional establishments to secure their political and economic future, this process was not necessarily a "hostile takeover", as paternalistic local administrations were indeed able to provide some cushion against the shock of chaotic transition. That gave regional leaders a valuable opportunity to create loyal constituencies in their regions. Further development allowed them to sustain these constituencies, if not to strengthen them.

Indeed, since the interregional markets remain suppressed, structural distortions of the Russian economy prevail, and the opportunities to earn income in the marketplace continue to be heavily concentrated in a relatively few sectors and industries (see above), economic survival elsewhere requires massive transfers of wealth. In the institutional void in the Russian economy, instead of a badly needed market reallocation of population, labor and other factors of production, broad-scale extra-market redistribution of the national product is taking place (Polishchuk, 1996). This redistribution is centered at the federal government, and is accomplished through the federal budget. Ironically, the state, which attempted to withdraw from the economy, and in particular to cut subsidies and refrain from allocative decisions as much as possible, has been brought back to become a hub of what is known in Russia as the "bureaucratic market".
To do well in such redistribution, the participants need to be properly organized in sufficiently large and influential groups, able to pool different kinds of politically valuable resources. It includes both economic resources and group mobilization. Given the embryonic stage of civil society in Russia, parties, trade-unions and other extra-territorial forms of group mobilization are still to fully develop. In the meantime regions are natural and immediately available alternatives, with already existing political elites and institutional bases. Besides, fiscal federalism provides natural and legitimizable channels for redistribution sought for.

That these channels are indeed being vigorously used, is illustrated by the following data (Lavrov, 1995): in 1994 10-12 (out of 89) subjects of the Russian Federation - primarily the capitals and resource-rich regions, with about 1/3 of the country's population - generated almost 60% of the revenues of the federal budget, whereas for 23 recipient regions transfers from the federal budget were at least twice as large as the federal taxes collected in the regions. Altogether, transfers to the regions amounted to 30% of the federal budget's revenues, and more than doubled direct transfers to individuals (welfare, unemployment and family benefits) (OECD Economic Survey, 1995). In addition, the disbursement of most of social benefits has been shifted - de jure and de facto - to the regions from the center.

Given the overwhelming role of the regions in social support and redistribution of wealth, it comes as no surprise that regional administrations are perceived by local population as indispensable representatives of regional interests in the "bureaucratic market". This is in sharp contrast with the mentioned above indifference of members of the Duma to regional needs. No wonder incumbent governors fare much better, than the MPs, when it comes to re-election. In December, 1995, 11 out of 13 of such incumbents were able to secure their positions for the second term, with their election campaigns based on heavy criticism of the federal authorities (Segodnia, April 9, 1996). It is also symptomatic that while non-payments of the Russian firms of taxes due to the federal budget are endemic, regional taxes are paid much more accurately (ibid, February 28, 1996). As a result, "the share of the federal budget in the consolidated budget fell abruptly from 48% in March [1996] to 35% in April, showing that regional authorities were better able to generate tax revenue than was Moscow" (OMRI Daily Digest, 26 June 1996).

Local administrators, therefore, have, at least potentially, two important advantages - solid social support and levers of effective control over local economies and societies - what is known in Russia as "the executive vertical". Federal authorities lack both, which makes them dependent on the subnational level bureaucracies, and susceptible to the latters' attempt to overhaul the division of power in the country.
Initially - from late 1991 through 1993 - the relations between the federal and regional administrations took the form of acute confrontation. Chaotic changes in the state and economy and lack of a consistent, operational and unchallenged constitutional framework cleared a playground with virtually no rules and constraints. Broad range of potentially available outcomes justified investments of vast resources to tilt the final arrangements towards the desired end. To further reinforce the incentives, winners could expect that their gains would be carried over into a secure and politically stable future, so that not just one-time payoffs, but capitalized streams of lasting economic and political benefits were at stake.

For the time being attempts of local administrations to expand their jurisdictions well beyond anything rationalizable as a federal system met little resistance from the Center, which was incapacitated by internal strifes - first between the Russian and Soviet governments, and later between the president and the Supreme Soviet. In fact, the sides to the struggle for power in Moscow were willing to offer to the regions - in order to win their support - otherwise unjustifiable concessions (hence Yeltsin's infamous "Take as much power, as you can swallow"). Another step in the same direction was the 1992 Federal Treaty, where regions-signatories were given the status of "constituent units" of the Russian Federation, and ethnic republics were offered the clause of "sovereign states".

These concessions fueled the escalation of demands of regional elites, who were increasingly taking under their control local economies, financial systems, law-enforcement and, most notably, public finance. "Unfunded mandates" to provide social services dumped to the regions by the federal government were the main justification for withholding locally taxes earmarked for the federal budget. Regions were also encroaching into such exclusively federal areas of authority as foreign trade, immigration and international relations. To build a legal base under this rapid expansion of regional jurisdictions, local governments started political campaigns, known as "sovereignty parade", to elevate status of their territories to "republics" and therefore to win the coveted clause of a "sovereign state".

These trends created a political equilibrium in that no region had an incentive to switch from unilateral jurisdictional proliferation and defiance of federal authorities to conventional federal-provincial relations. According to (Sachs, 1995), such an equilibrium is based on the following "numerical externality": when the majority of subnational governments repudiate the federal administration and deny it essential resources, such behavior entails for every participating region considerable benefits at negligible cost, as incapacitated federal authorities are unable neither to sizably reward loyalty nor to punish disobedience.
Being behaviorally stable, such an equilibrium was at the same time fraught of "fiscal meltdown" of the federal government, deep fragmentation of the institutional setup of the Russian economy, and the break-up of Russia into a loose conglomerate of quasi-state entities. To reverse these trends, Yeltsin had no other choice but to resort to extreme measures. The 1993 crackdown on political opposition in Moscow was in fact a two-pronged measure, aimed, besides its immediate target - the conservative Supreme Soviet, at rebellious regional leaders as well. The display of determination created a "focal point effect", which produced a new equilibrium based on commonly shared expectations (of the federal governments' abilities and resolve), which became a self-fulfilling prophecy.

The post-October political equilibrium in federal-provincial relations in Russia excludes confrontation as the prevailing mode of behavior. The new constitution has laid a framework that is accepted by all major political forces in the country. While criticism and condemnation of particular offices, policy measures and representatives of the federal administration remain widespread in the Russian regions, nowhere in Russia, except for Chechnia, open defiance of the central government and threats of secession remain options for political mainstream.

The new equilibrium, however, has failed to create a harmonious federal system, and in particular to re-orient subnational governments from the federal scene to their local constituencies. Regional administrations are still heavily involved with the federal authorities, but this time the nature of this involvement could be best described as bargaining (Solnik, 1995).

5. The "Grand Bargain"

Bargaining in general permeates the political life of modern Russia, which is quite natural given the immaturity of the country's political system with main institutions still in flux and feedbacks from the bodies of power to the electorate weak and easily manipulable. Other reasons are economic. First, as it was already mentioned, numerous failures of the Russian market require massive redistribution of economic wealth by extra-market means, and the system of "side payments" supporting such redistribution should be negotiated. Secondly, chaotic division of property, wealth, power and economic roles could hardly be expected to produce an efficient allocation of economic and political assets, and massive Coasian bargaining couldn't but ensue. For the reasons presented above the regions are among the key parties to this bargaining.

At the same time, there seem to be a consensus among the involved parties to mutually respect basic rules which secure roles in the game and prevent an all-out "war of attrition". These rules,
which were primarily laid down by the federal constitution adopted in December, 1993, are not too binding. To ensure a prompt passage of the constitution, the latter was made deliberately vague on many potentially contentious counts, including federal-provincial relationships (Articles 71 and 72 are particularly notorious for their lack of unequivocal operational content). While abstract language is commonly used in constitutions to reflect the generality of the document and to make it adjustable to unforeseeable future circumstances, it is usually up to the courts to interpret and specify constitutional provisions (Posner, 1987). In Russia, with its legal system lagging behind political reform, and embryonic legal culture and traditions, courts could not play any major role in resolving constitutional disputes, and backstage bargaining prevails instead.

It turns out that opportunities for such bargaining still remain broad enough to accommodate the interests of regional elites and the central authorities, although the outcomes, while being mutually acceptable to the parties, quite often defy the principles of economic and administrative efficiency and social justice. While the new constitutional environment has succeeded in putting an end to anarchy in federal-provincial relations, it has failed nonetheless to accomplish another important end, stressed by Madison in his Federalist Paper Number 10 - that is, while facilitating freedom of political actions, to restrain activities that promote interests of narrow factions at the expense of the rest of society: as "the causes of factions cannot be removed, ... relief is only to be sought in the means of controlling its effects" (Hamilton, Madison, Jay, 1961).

One of the main features of federal-provincial bargaining in today's Russia - its enhanced focus on institutionalized long-term arrangements, rather than on one-time financial transfers that were common targets of earlier lobbying activities. This emphasis reflects commonly held expectations that the current pliancy of the legal and institutional framework is a temporary phenomenon that should be exploited until the transition is over and new arrangements harden. In the meantime short-term weakness of partner could be capitalized upon to win lasting entitlement secured by the rule of law.

In pursuit of such entitlement regions are currently using two main vehicles - regional charters (ustavs) and bilateral treaties with the federal authorities. Both of these vehicles are spin-offs of provisions first wrested from the Center by ethnic republics which managed to form a strong coalition thus boosting their bargaining position vis-a-vis the federal authorities (Solnik, 1995). In particular, the republics have secured an exclusive right to have their own constitutions, while non-ethnic units of the Russian Federation - oblasts and krais were offered to draft charters as constitutional surrogates. Despite of its subconstitutional status, the regional charter turned out to be an efficient means to exploit vagueness of the federal constitution in the sphere of intergovernmental relations, and to fill the void by unilateral provisions customized to the needs.
of regional bureaucracy. That many charters are indeed meant to serve this aim, instead of their primary purpose - to set provisions for local governance and democratic processes within the region - could be seen from their emphasis on "external" relations of the region with the federal administration (Smirniagin, 1995).

Still, charters are subject to potential federal scrutiny, and therefore their provisions are less reliable and secure than bilateral arrangements that have an explicit blend of approval from the federal government. Such arrangements are available in Russia in the form of federal-regional treaties. First secured by republics, these treaties are now targets of choice for other regions as well. By summer, 1996, nineteen (out of 89) subnational units of the Russian Federation have had such treaties, with other regions ready to follow suit, and more treaties in the pipeline.

Other forms of preferential treatment and customized arrangements include regional development programs (Komi Republic), "free economic zones" (Republic of Ingushetia, to be followed by Kaliningrad region), exemptions from the federal privatization program (Moscow), exclusive fiscal agreements (Tatarstan, Bashkortostan, Yakutia and Komi), and federal assistance programs to depressed regions ("One can expect interregional contest for the right to "proudly carry" the status of a depressed region" - Leonid Smirniagin, Izvestia, July 23, 1994). The common feature of these arrangements is that most of them are products of bargaining, rather than being "rationalizable" by compelling objective criteria. "Exceptions [have been] made for by no means the weakest ... republics whose industrial and export potentials had been earlier created by efforts of the whole nation" (Lavrov, 1995). Another evidence of political underpinnings of "regional privileges" is that the benefits are heavier concentrated in the regions that were (electorally or otherwise) in opposition to the federal government (ibid).

Discretionary treatment of regions coexists with blanket concessions to the regional elites at large. Most notably, it includes the special role of the regions in privatization of locally managed assets - a move explicitly designed to "buy out" regional administrations as one of the major "stakeholders" in privatization (Boycko, Shleifer, Vishny, 1993). Another attempt to integrate regional elites in the federal political establishment is the law on the Council of Federation - the upper chamber of the Russian parliament which is formed by heads of regional executive and legislative bodies of power.

The regions are by and large reciprocating by pledges of loyalty to the federal government. In the new post-confrontational political environment even those regional administrators who were in the recent past most unyielding and defiant vis-a-vis the federal authorities, now prefer to
bargain for a lasting settlement, where parties trade benefits with each other. There are numerous examples illustrating this trend (see e.g. McFaul, Petrov, 1995). Sverdlovsk region governor E. Rossel, earlier at loggerheads with the president over the idea of the "Urals Republic", was sacked by Yeltsin in 1993 as a part of the overall crackdown on political opposition in Moscow and regions. An unrepentant Rossel was able to capitalize on strong popular support and to arrange for an impressive comeback to politics through the series of election victories (the Federation Council, the local legislature, and finally the gubernatorial elections). Back in office, however, Rossel prefers to avoid further confrontation with the president, and in fact, started his term with a visit to Moscow, which apparently resulted in a compromise. The creation of "Urals Republic" was put on the backburner, although not abandoned altogether.

Another example is the Republic of Tatarstan, whose leadership was in seemingly irreconcilable confrontation with federal authorities over the issues of sovereignty and self-determination. The republic boycotted the federal referendum of 1991 and subsequent presidential and parliamentary elections. However, after the Center has caved in to the demand for a bilateral treaty on the division of jurisdictions between the federal and republicans governments, the situation changed radically, and now the republican leadership frequently displays loyalty to Moscow.

Still, the support of the federal government and the president by regional establishments is anything but unconditional, and not infrequently doesn't go much beyond lip service. The attitude of regional leaders to the pro-government electoral block "Russia is Our Home" serves as a good illustration. The majority of heads of regional administrations either joined the block or expressed their support of it (McFaul, Petrov, 1995). However, the lack of electoral success of the block is a clear indication that the actual support rendered by regional authorities was limited at best, especially given the increased influence of the regional elites on elections (Constitution Watch, Russia, 1995).

Apparently, given the overall political uncertainty and poor popular rating of the Center, regional leaders refrain from fully backing the current federal administration, as such support could jeopardize their relations with the next government. Unlike members of the federal parliament, the heads of regional bodies have a long term political horizon, and need to be careful in allocating their political resources intertemporally. They view the opportunity to throw their support behind the feds as a call option that will be cashed when the time is right. In the meantime, the local leaders keep their communication channels to the Center open and use the prevailing uncertainty to strike the best possible deals.
6. Negotiated Federalism: An Assessment

The present mode of federal-provincial relations in Russia is much more sustainable than the pre-October, 1993 "confrontational equilibrium". Both the federal and regional authorities have stakes in the status quo, and need each other to maintain it. As for bargaining as the main mode of interaction, it is not necessarily a counterproductive way to refine the Russian constitutional framework and to adjust it to the country's needs and realities. Still, there are reasons to be skeptical about the ability of the Russian "bureaucratic market" to produce a functional and efficient federal system.

Bargaining between the regions and the federal government is an example of what is known as influence activities, where resources are being spent at the lower level of a hierarchical system to produce (influence) desired higher level decisions. Such activities, being directly unproductive, could nonetheless turn out to be productive indirectly as a means to furnish for the center otherwise unavailable grass-roots information, required for efficient separation of jurisdictions, tax and spending powers. In other words, bargaining could be indispensable in reducing informational asymmetry - a task, particularly important as the Russian federalism has virtually no past experience to rely upon.

The criterion as to whether influence activities are indeed producing efficiency gains looks as follows (Milgrom, Roberts, 1988): such activities are (or at least could be) ultimately productive if they are aimed at decisions of direct importance for efficiency of the "organization" at large (in our case - of the federal system of governance). If, however, influence activities target matters of limited (if at all) consequences for overall efficiency, but of great importance for individual participants, such activities are primarily redistributitional in their nature and should be suppressed.

As it was already stressed, the records of federal-provincial bargaining to date indicate that re-distributive motives clearly prevail over efficiency-related rationales. "The most alarming [feature of the recent redistributive trends] is not the direction of these trends (every budgetary innovation would leave "gainers" and "losers"), but that all the changes look arbitrary and by no means justifiable from the viewpoint of goals of federal regional policies" (Lavrov, 1995). Analysis of bilateral treaties between the federal government and republics further corroborates the above conclusion, as these treaties are essentially exclusive transfers of ownership and jurisdictions from the center to the republics. Most of these arrangements are clearly based on political bargaining power of individual regions (Lavrov, 1995; Solnik, 1995), so that overall efficiency gains could be accidental at best.
Efficiency losses due to federal-provincial bargaining in Russia go well beyond the opportunity cost of resources invested by the local governments into mainly redistributive activities. The process also incapacitates the federal administration, which is under permanent pressure to spend its resources for buying compliance of regional counterparts, instead of providing mandated public goods. The federal government accountable to regional lobbies rather than to the nation at large is faced with distorted political incentives. Fiscal and political resources that the government controls could be spent either for provision of public goods and inputs (law, order, market infrastructure, social safety nets etc.) or for subsidies to narrow interests. Encompassing (Olson, 1965) interests of the nation emphasize overall economic efficiency and put the first option ahead of the second one. On the other hand, a regional administration with a relatively narrow economic base would strongly prefer a subsidy to the contribution of the same amount of resources towards the provision of public inputs. When direct (rather than through regional administrations) channels of accountability and communication of political preferences are absent or heavily suppressed, the provision of public goods and inputs depends on individually crafted agreements with private parties, and these goods end up being dramatically underprovided. Instead, direct and indirect subsidies are claiming a lion’s share of the state budget. As a result, preconditions for economic restructuring keep being missed, which reproduces the pervert political environment and sustains the regional lobbies (see also the Appendix).

Fiscal concessions made to the regions greatly complicate the crucial tasks of balancing the federal budget, reducing the cost of borrowing, and achieving overall financial stability while still delivering essential services assigned to the federal government and paying the bills of its contractors (Wallish, 1994a). The standard reaction to the insufficiency of federal revenue is in shifting unfunded social expenditure responsibilities down to the regions. That not only goes against the fundamentals of fiscal federalism, which assign social safety nets and other similar programs with broad interregional spillovers to the federal government (Oates, 1972), but also further fuels re-distributive efforts, as cash-striped regions are vigorously seeking redress through the same bargaining channels (Wallish, 1994b).

Last but not least, individually crafted arrangements with regions hurt economic efficiency because they undermine institutional unity and homogeneity of the Russian markets and as such are tantamount to interregional economic barriers. Broad discretion of regional administrations establishes mutually inconsistent regimes of private property, local price controls, subsidies, restrictions on free movement of commodities, capital and population, creates and/or protects local monopolies (Wallish, 1994b) etc. The central authorities do not put up adequate resistance to curb these trends, which not only undermines allocative efficiency of the Russian economy, but clearly goes against the federal constitution.
In fact, knitting the Russian market as a patchwork of regionally crafted institutional arrangements was even encouraged as ostensibly a way to promote the reform "from bottom up". This policy, consistent with the overall approach of "downloading" functions of the federal government to the regions, was apparently an attempt to capitalize nationwide on more favorable political climates for radical reform in some areas of the country. The expectation was that these areas would fare socially and economically better than their conservative neighbors and the latter, having learned these visual lessons, would have an incentive to import "progressive" economic environments. This "emulation theory", which itself emulates Max Weber's (1989) views of establishment of the Protestant ethics as the foundation for institutions of modern capitalism, has, however, little chances to be successfully applied to Russian regions. Full-fledged nationwide market in Russia is a crucial precondition for recovery of depressive regions, and until such recovery trickles down, neither political preferences of local population nor the incentives of regional elites will not turn towards economic liberalism. And indeed, the liberal-conservative interregional dichotomy in Russia ("Nizhny Novgorod vs Ulianovsk") shows few signs of erosion (McFaul, Petrov, 1995).

By making fundamental institutions of the market economy negotiable with regional bureaucracies, the federal government in Russia effectively reneges on its obligation to establish such institutions as a public good available throughout the country. Failure to fulfill this obligation is perhaps the gravest threat both to economic efficiency and political stability in Russia. It was argued earlier in the paper that segmentation of the Russian markets and inequality of economic opportunities in different regions are among the main causes of malfunctioning of the Russian federal system and, for that matter, of the country's democratic institutions. It follows that the political feedbacks described above reproduce this inequality and further forestall badly needed economic restructuring.

The above analysis indicates that Russia fails the fundamental tests of "market-preserving federalism" (Weingast, 1995) - in other words, of a federal system which is conducive for economic efficiency and imposes self-enforcing restrictions on counterproductive discretion in economic policy making. These tests include the requirements that "a common market is ensured, preventing the lower governments from using their regulatory authority to erect trade barriers against the goods and services from other political units, and ... the lower governments face a hard budget constraint" (ibid). In such an environment broad decentralization of regulatory responsibilities serves economic efficiency well, since local governments compete with each in providing best business and living conditions, and receive prompt response from mobile capital and labor. Economic discretion of the central government beyond protection of the interregional markets, enforcement of contracts and property rights and provision nation-wide of a few other
similar public goods, is strictly limited, which precludes counterproductive transgressions to favor narrow interests. In this case the federal government "is strong enough to maintain law and order, but too weak to launch and implement ambitious schemes of economic regulation or to engage in extensive redistribution ... - probably the optimal government for economic growth" (Posner, 1987).

As opposed to the cited requirements, in Russia budget constraints of most of the regional governments living off the federal subsidies are soft, and the national market, underdeveloped as it is, is further segmented by regionally established man-made barriers. That preserves broad interregional diversity of economic preferences, and "under these circumstances, the nature of citizen views about the appropriate role of the state and what actions constitute a transgression are likely to differ widely. [That] will result in one of the asymmetric equilibria in which the sovereign transgresses the rights of some and retains the support of others" (Weingast, 1995; see also Ferejohn, 1990). Instead of a broadly based grass roots consensus against redistributive transgressions of the federal government, the Russian federal authorities are pressed hard by the regions to be engaged in such transgressions. The resulting model of federalism is, quite obviously, market-contravening, rather than market-preserving.

Another conclusion is that "downloading" of economic reform from the federal to regional authorities that apparently has produced an efficient version of market-preserving federalism in China (Weingast, 1995), is not an unconditionally applicable recipe for success. This policy works well if opportunities for earning market income are sufficiently spread throughout the country, which creates incentives for regional politicians to nurture nascent markets and protect them from encroachments of federal bureaucrats. If, however, such opportunities are heavily concentrated in a few areas, leaving a majority of the nation economically disenfranchised, regional authorities use their discretion in economically counterproductive ways.

Analysis of incentives and political resources of the participants of the "federal-provincial N + 1 person bargaining game" (Ordeshook, 1996) doesn't indicate immediate ways and means to harmonize the situation and to put it back in the domain of constitutional federalism. As we already mentioned, the status quo is a political equilibrium, at least for the regions. As for the federal government, it was able to curb regional defiance (except Chechnia), but doesn't have sufficient resources to enforce compliance. These resources could be twofold - administrative coercion and/or moral authority based on strong popular support. The first option is precluded, both because the main argument of using force in 1993 - a necessity to establish an adequate constitutional framework - is not available any longer, and because of poor efficiency and dubious loyalty of the "power ministries". Moral authority is dwindling alongside with social support of
the center. Therefore seeking compromises with regional elites, which enjoy much stronger social bases, seems to have no alternatives in the short run.

This equilibrium could only be unraveled if the economic distortions it feeds upon are gone. When fully functional markets integrate Russian regions, the demand for extra-market interregional redistribution will subside, and nation-wide economic interests will become at least commensurable with those based locally. At this point national parties will come to play and assume the federal political scene, relegating local elites primarily to the subnational level.

Appendix

The following political-economic equilibrium model illustrates how interregional inequality breeds political instability and uncertainty within a federal state, and how the instability, in its turn, reproduces inequality. These links between inequality and uncertainty are based on interregional disparity of preferences over policy issues falling into the federal jurisdiction, and in particular over the provision nation-wide of public production services, such as market infrastructure, institutional foundations of the input markets (including necessary social services and safety nets), protection of property rights, maintenance of law and order, etc. It is assumed in the model that "private" production inputs, such as capital, are complementary to the public inputs, and failure of the federal government to credibly deliver the latter undermines the incentives in the regions to accumulate their capital stocks.

Consider an economy comprising two regions. Each region has the same inelastically available quantity of labor, but different endowments of production assets (capital). This assumption captures the aforementioned inequality among the Russian regions in their capacities to produce market income. The model of regional technologies, adopted from recent studies of economic growth (see e.g. Alesina, Rodrik, 1994), is described by production function \( Y_i = F(K_1, G) \), where \( K_1, K_2 \) are capital stocks of regions 1, 2, and \( G \) - the amount of the aggregate public input (available in the same quantity throughout the two-region economy). Function \( F \) is assumed to meet the standard neo-classical requirements, and in particular to feature constant returns to scale.

Suppose that the budget of the federal government is \( B \) and could be spent either to fund the provision of the public input, or for subsidies. Assume for simplicity sake that public funds earmarked for subsidies will be split among the regions equally. A region can use the subsidy as
investments to increase its capital stock, or, alternately, for immediate consumption. The only policy variable of the federal government is the amount of the public input \( G \in [0, B] \), with the balance of the federal budget \( B - G \) to be spent for subsidies. It is further assumed that subsidies are secured by the regions, whereas the public input will indeed be made available only if the current federal government stays in the office - otherwise an ensuing political turmoil will render the funds to be spent for the public input a sunk cost. The probability that the federal government will stay in power is \( \pi \) and is known to the regions.

A region with initial capital stock \( K \) determines its preferences over the federal policy by solving the following optimization problem:

\[
\max_{x, g} \left\{ \pi F(K + X, G) + \frac{1}{2} (B - G) - X \right\},
\]

subject to the constraints \( G, X \geq 0, \ X \leq \frac{1}{2} (B - G) \). Here \( X \) is the part of the subsidy that will be spent for investments. The last inequality means that regions can not borrow money to fund their investment programs in the amounts exceeding the available subsidies. The model (A.1) assumes that regions are risk-neutral.

It is convenient to normalize variables \( K, X \) and \( G \) by dividing them over the available federal budget \( B \). After such normalization has been performed, which is reflected by replacing capital letter notations by small ones, the problem (A.1) takes the following form:

\[
\max_{x, g} \left\{ \pi F(k + x, g) + \frac{1}{2} (1 - g) - x \right\},
\]

subject to the constraints \( g, x \geq 0, \ x \leq \frac{1}{2} (1 - g) \).

We will need an assumption about the technology \( F \) that if the federal government is fully credible (\( \pi = 1 \), then under no circumstances a region's optimal choice would provide for consumption subsidies. To formalize this assumption, let \( F(k, g) = g f(k/g) \), where \( f \) is a single-input production function (such representation of the technology always exists due to \( F \)'s constant returns to scale), and assume that the following condition holds:
\[ f'(z) = 1 \Rightarrow f(z) - z f'(z) > \frac{1}{2}. \]  

(A.3)

This condition implies that when the marginal product of capital falls down to unity (which is the capital’s opportunity cost in consumption), then instead of spending the still available amount of subsidy for consumption, the region will prefer to reduce the subsidy in favor of the public input. Of course, if the provision of the public input is less than fully credible, consumption subsidies might become an attractive option.

To describe the dependency of the optimal solution of (A.2) on \( k \) and \( \pi \), introduce functions \( a(\pi) \) and \( b(\pi) \) implicitly defined by the following equations:

\[ \pi f'(a(\pi)) = 1; \quad \pi [ f(b(\pi)) - b(\pi) f'(b(\pi)) ] = \frac{1}{2}. \]  

(A.4)

One can easily check that \( a(\pi) \) is monotonically increasing and \( b(\pi) \) monotonically decreasing, with \( a(0) = 0 \) and, due to (A.3), \( a(1) > b(1) \). (We assume that \( f''(z) < 0 \), \( f'(0) = \infty \), \( f'(\infty) = 0 \).) It means that there exists a unique value \( \pi^* \in (0, 1) \) such that \( a(\pi^*) = b(\pi^*) \). Denote the latter common value as \( z^* \).

**Proposition 1.** The optimal solutions of problem (A.2) look as follows (see Figure):

if \( k > \min (b(\pi), z^*) \) (area I), then \( g = 1, x = 0 \);

if \( k \leq b(\pi), \pi \leq \pi^* \) (area II), then \( g = k / b(\pi), x = 0 \);

if \( k \leq z^*, \pi^* \leq \pi \leq 1 \) (area III), then \( g = \frac{k + \frac{1}{2}}{z^* + \frac{1}{2}}, x = \frac{z^* - k}{2z^* + 1} \).

It is worth mentioning that in area II all of subsidies are consumed, since low credibility of the federal government stifles investments. On the contrary, in area III all of subsidies are invested.

According to Proposition 1 (we omit the proof), there is no discord among the regions if they are equally endowed with capital. Less trivially, there is no discord also when capital endowments, while being different, _are both large relatively to the federal budget:_ if
$k_i > z^*$. $i = 1, 2$, then every region would prefer that the federal government spends all of its budget on the public good - provided, of course, that the public good will indeed be delivered. The latter condition doesn't seem to raise concerns, since the federal government will be able to satisfy both of the regions by meeting their identical first-best requirements, and therefore the political basis of the federal government will be sufficiently firm. As a result, $g = 1$, $n = 1$ will be a political-economic equilibrium. To describe this equilibrium differently, if the federal budget is small relatively to the capital endowments of the regions, the regions will not be laying claims for subsidies, the federal funds will be spent for the public input, and the federation will be politically stable.

Stability will also be ensured if both regions are poor in capital relatively to the federal budget, so that $k_1$, $k_2$ are small. In this case, according to Proposition 1, regional demands for the public input will be both close to $1/(2z^* + 1)$, and hence also easy to reconcile. In this case both regions will be subsidized, but because of homogeneity of their preferences the federal government's provision of the public input will be assured, and subsidies will be spent for investments - as it is predicted by condition (A.3).
Otherwise regional preferences over federal policies could be quite distinct due to disparity in capital endowments, ranging from \( g = 1 \) to \( g = 1/(2z^* + 1) \). In this case any decision of the federal government will leave at least one of these regions frustrated, and this frustration will be undermining political stability. It will damage the perceived credibility of the federal government, and the regions will re-adjust their policy preferences to account for lower \( \pi \). That will suppress their demands of the public input and hence will bring these demands closer to each other. As a result, a political-economic equilibrium will emerge with a possibility that the federal government will fail.

To describe such equilibrium, assume that the probability of the government’s survival is a monotonically non-increasing function of the discrepancy in regional policy preferences:

\[
\pi = H(\mid g_1 - g_2 \mid)
\]  \hspace{1cm} (A.5)

with \( H(0) = 1 \). We say that \( g_1, g_2, \pi \) form a political-economic equilibrium, if in addition to (A.5) \( g_1, g_2 \) are the optimal solutions of problems (A.2) for regions 1 and 2. According to Proposition 1, when \( \pi \to 0 \), optimal demand for the public input, quite naturally, tends to zero, which ensures the existence of an equilibrium. It is easy to check that such equilibrium is also unique, and we arrive to the following conclusion.

**Proposition 2.** For any capital endowments of the regions, there exists a unique political-economic equilibrium, which in general allows for a failure of the federal government.

In case of profound disparity in the regional capital endowments the equilibrium will involve a low probability of the federal government’s survival - in other words, disparity breeds political instability. Moreover, if the instability is serious enough so that the equilibrium belongs to area II for the region with is poor in capital, this region will, despite of its lack of production resources, invest none of the federal subsidies that will all instead be consumed - hence instability reproduces disparity.
References


