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# EERC Policy Brief

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## Achieving stability in heterogeneous societies

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### To divide or to unite?

In many social, political, and economic situations individuals form groups rather than operate on their own. Countries coalesce in order to resist threats posed by external enemies, communities unite to share the costs of local public goods, and workers join labor unions to secure better employment contracts. In these situations individuals come together to take advantage of the increasing returns to scale provided by large groups.

Russia, China, India and other countries, however, themselves are composed of heterogeneous groups of individuals and regions. Wealth, culture, language, religion, geography, climate, and historical experience differentiate these groups. Distinguishing characteristics within a country might be linked: different climate conditions, for example, promote different paths of industrial and agricultural development — a connection evident in the Mediterranean region of Europe and the southern United States. Consider, for instance, the US civil war, which was born out of attempts to impose uniform standards upon the economic and social heterogeneity within the young US federation. This observation supports the claim that the benefits of combination, the economies of scale, are not unlimited: in some situations, a decentralized organization is superior to a large, more unified social structure. Thus, instead of a “grand coalition” containing the entire population, we may observe the emergence of multiple subgroups smaller than the grand coalition.

### Political economy context

The political economy of country formation and stability suggests that there are good reasons for a heterogeneous country to remain united, despite the fact that the resulting centralized policies will not be ideal from the point of view of individual regions. Chief among these reasons is, as already noted, the benefit from combination in facing external foes. But if some regions are displeased with the centralized policies, they may choose to secede. What characteristics are required to preclude such secession, to

guarantee the stability of the unified country? For example, is such a diverse country as Russia stable? And how is the diversity of Russian citizens accounted for in the relations among the regions of Russia?

### Increasing returns versus heterogeneity: no way out?

The stability of a union or even of smaller subgroups, then, depends on the tradeoff between capturing increasing returns to scale and satisfying diverse preferences. Is it possible that a society that is not sustainable in operating as only one group, the grand coalition, could be partitioned into several groups that would be jointly stable? Could a federal structure be developed that would provide substantial joint benefits, while sufficiently responding to individual preferences, such that people within the federation would not seek out a different arrangement? The federal structure might offer a large degree of subgroup autonomy, for instance, to increase the scope for responding to regional differences and disparities.

If people or regions differ in only a single characteristic — their interest in public parklands, say — then it would seem that a federal structure consisting of two regions, each with the delegated authority to choose the extent of its public parks, would provide a stable structure. But if regions or individuals differ in many respects, then finding a stable federal organization might be harder. In other words, the existence of stable structures is crucially dependent on the dimensionality of the “policy space”. In general, the severity of preference divergence rises when the number of policy dimensions on which disagreement is possible increases; with many dimensions of diversity, the search for a stable group structure becomes more challenging. Nevertheless, even simple, one-dimensional policy spaces (say, the choice of where to locate the capital city) might not permit a stable federal structure, even as the unified, grand coalition would also fail to be stable.

### Stabilizing transfers: back to socialism, or equalization works

But the central government might have other policy levers at its disposal, beyond grants of autonomy. Sophisticated use of such policy instruments, then, might induce stability within a federal structure. One possibility would

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be to limit the dimensions of potential disagreement, perhaps by altering the preferences of individuals and regions. But changing the political preferences of a diverse population in a predictable direction is no easy task (nor is altering climatic or geographical characteristics!) But governments also control fiscal policies. In practice, central governments often target subsidies, directly or indirectly, towards dissatisfied or disadvantaged groups or regions (e.g., Navarra and the Basque country in Spain, the south of Italy, the Atlantic provinces in Canada, and the western provinces in China).

In our theoretical modeling, we examine the possibilities for fiscal transfers to promote stable federations. What we find is that transfer programs that provide a type of equality can indeed support the stability of a federation. Specifically, in societies where the 'costs' within each

group are divided equally among members, a stable group structure always exists. The relevant 'costs' are quite general, and go beyond direct monetary costs. The total costs within a group include the expenses of government operations, plus the sum of personalized costs borne by residents in the form of their dissatisfaction with the adopted policies — policies which typically will be less than ideal from the perspective of the residents. Fiscal transfers could be used to equalize these costs, and hence to ensure stability.

The theoretical result suggests an empirical follow-up: the characterization of transfer schemes implemented in various countries. In particular, to assess the potential stability of the Russian Federation, we can contrast its transfer formulas with the redistribution mechanisms employed in Europe, Asia, Australia and North and South America.

The Economics Education and Research Consortium, Russia and CIS (EERC) is a non-governmental non-profit charity foundation. Its main purpose is to strengthen economics education and research capabilities in the CIS. The initial focus of EERC was on graduate level education (in Ukraine, <http://www.eerc.kiev.ua>) and research (in Russia, <http://www.eerc.ru>).

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