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Interest group politics in a federation

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ABSTRACT

The optimal degree of decentralization depends on the importance of inter-state externalities of local policies. We show that inter-state externalities are determined by the spatial distribution of interest groups within the country. Interest groups who have multi-state scope internalize inter-state externalities to a larger extent than the lobbyists with interests within a single state. We use variation in the geographic boundaries of politically-powerful industrial interests to estimate the effect of inter-state externalities on firm performance. Using firm-level panel data from a peripheralized federation, Russia in 1996–2003, we show that, controlling for firm fixed effects, the performance of firms substantially improves with an increase in the number of neighboring regions under influence of multi-regional business groups compared to the number influenced by local business groups. Our findings have implications for the literatures on federalism and on international trade as trade restrictions are a common source of inter-state externalities.

1. Introduction

The main normative question of federalism is how to resolve the tradeoff between costs and benefits of decentralization. The benefits of decentralization come from the better use of local information (Hayek, 1948) and stronger fiscal and political incentives of government officials (Tiebout, 1956). The main cost is associated with inter-state externalities, i.e., a situation in which subnational authorities do not fully internalize the effects of their policies on other states in the country (Musgrave, 1969; Oates, 1972). Externalities are inherent in many state policies, such as state trade restrictions, regulation of factor mobility across state borders, investment in public infrastructure, pollution control, state capital taxation, issuance of surrogate currency, etc. How important are inter-state externalities? What determines their magnitude? This paper sheds light on the role of interest group politics in inter-state externalities.

In his classic work, Riker (1964) associated large inter-jurisdictional externalities with "peripheralized" federalism—in his terms, federalism with weak nationwide political institutions, and low externalities with "centralized" federalism—federalism with strong nationwide political institutions. In particular, he argued that strong national political parties generate career concerns for local public officials to be promoted to the national-level politics which, in turn, helps internalization of inter-state externalities.[1]

Riker's theory, however, does not explain how strong nationwide institutions emerge and why they form in some countries and not in others. We argue that the theory of interest group politics (Olson, 1982; Grossman and Helpman, 1994, 2001) can help answering these questions. According to Grossman and Helpman, inefficiencies in the political process stem from the inability of certain groups to organize themselves. Suboptimal policies emerge because organized interest groups neglect the welfare of non-organized groups. Therefore, broader scope of interest groups leads to more efficient

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[1] Riker's theory found solid empirical support; see, for instance, Enikolopov and Zhuravskaya (2007).

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outcomes. We extend this logic to the analysis of interest groups in a federation.

The spatial distribution of politically-important industrial interests has an effect on inter-state externalities. In particular, multi-state interest groups internalize the inter-state externalities of local policies to a larger extent than powerful industrial lobbies with interests in a single state. Therefore, politicians in a federation with multi-state interest groups have a greater stake in the national welfare, which may result in the formation of nationwide political institutions. The equilibrium policies that result from lobbying by multi-state groups have lower negative (and higher positive) externalities. For example, trade barriers set by states with powerful lobbies comprised of multi-state business groups are lower than barriers set by states in which the most powerful interest groups are local. In addition, states with powerful multi-state lobbies may even be less protectionist than states with perfectly accountable (non-captured) governments who oppose trade for fiscal reasons or due to terms-of-trade effects.

We illustrate the difference in the effects of the multi-state vs. single-state lobbyists on the intensity of inter-state externalities with a simple model and test the model's predictions using data from Russia in 1996–2003. We merge two panel datasets: (1) a dataset on the performance of a regionally-representative sample of large and medium-size Russian firms and (2) a unique dataset on the geographical scope of powerful industrial lobbies in Russian regions. We show that the performance of an average firm depends on whether policies of neighboring regions are influenced by regional or multi-regional lobbies, controlling for a wide variety of factors, including firm fixed effects and macroeconomic trends. An increase in the number of neighboring regions with governments under political influence of multi-regional industrial groups (compared to having them being under influence of regional industrial groups) has a significant and substantial positive effect on the performance of firms operating in industries related to the lobby of the neighboring regions. We conclude that spillovers from regional policies lobbied by multi-regional industrial groups are significantly more benign to firms located in the neighboring regions compared to spillovers from regional policies lobbied by regional industrial groups.

In the general case, we estimate the reduced-form relationship between firm performance in one region and the scope of industrial lobbies in other regions. However, theoretically, there is an intermediate step in the analysis: lobbies affect regional policies and regional policies affect firms in other regions. We skip this step in the main empirical exercise because there are no systematic data on the actual policies that generate externalities for all industries and regions. In order to fill this gap, we conduct two additional exercises which shed light on policies in more specific contexts. In the first of these two exercises, we provide anecdotal evidence on inter-regional trade barriers as a source of these externalities. We present two case studies to illustrate this effect. In the first case study we show how a regional industrial group lobbied for erecting inter-regional trade barriers; once the very same interest group became multi-regional, it reversed its stance from protectionist to pro-trade. The second case study refers to the beer industry where many local producers have successfully lobbied for non-tariff inter-regional trade barriers in their regions. At the same time, the regions with the presence of multi-regional beer producers have never instituted such barriers. In the second exercise, we also provide systematic evidence on how the presence of multi-regional vs. regional alcohol producers in the Russian regions results in differential levels of regional import restrictions on alcohol and how these restrictions affect alcohol producers in the neighboring regions.

We focus on Russia in 1996–2003 as a unique constellation of political and economic factors makes it an ideal testing ground for an empirical study of the relationship between inter-regional externalities and geographical scope of regional lobbyists. Firstly, a high degree of economic and political autonomy of regional governors made Russia a typical example of Riker's "peripheralized" federalism. Secondly, industrial interest groups played a very important role in policymaking at all levels of government (including regional). Privatization in the early 1990s gave rise to a high concentration of wealth and, as a consequence, a high degree of state capture.[2] Thirdly—and most importantly—in order to estimate the impact of geographical distribution of interest groups over time, one has to assume that the over-time changes in the spatial distribution of assets belonging to large owners of privatized businesses are exogenous to the inter-jurisdictional externalities (controlling for fixed effects and over-time variation in the spatial distribution of value added). This assumption is admittedly rather strong, but it is more reasonable in the Russian context than elsewhere. The reason is that the scope of business groups has been determined by a combination of (i) the non-market-based industrial production chains inherited by Russia from the Soviet planning system (Bergson, 1961; Gregory and Stuart, 2001; Hill and Gaddy, 2003), (ii) the largely ad-hoc privatization process of the 1990s (Boycko et al., 1995; Shleifer and Treisman, 2000), and (iii) the consolidation of ownership by business groups at the end of 1990s and the early 2000s with the primary aim of vertical integration because of a high degree of contractual incompleteness (Guriev and Rachinsky, 2005). Thus, we consider Russia in transition a unique natural laboratory for measuring the effect of the geographical size of lobbies on inter-state externalities.

Since the assumption about the exogeneity of the over-time changes in the scope of interest groups is, nonetheless, a strong one and not testable directly, we supplement our baseline panel fixed effects analysis with the results of cross-regional analysis. In the cross-section, we are able to instrument the extent of regional capture with the initial industrial concentration and the type of regional capture with the share of the largest regional firms that were privatized during the initial 1993 privatization wave. The cross-sectional results are also consistent with our main hypothesis.

1.1. External validity

Inter-state externalities play an important role in every federation. The Founding Fathers of the United States understood this well as early as 220 years ago. After the Revolution and the Declaration of Independence, the Articles of Confederation provided individual states with substantial autonomy in economic policy. The states used this autonomy to erect high inter-state trade barriers. The authors of the Constitution argued that a common market is a necessary condition for the country's successful development and insisted on the Commerce Clause.[3] The Federalists (1787–1789) not only emphasized the importance of the common market for economic prosperity ("*active commerce in our own bottoms*," "*unrestrained intercourse between the States themselves*," Hamilton, Federalist Paper No. 11) and sustainability of the federation ([*the absence of the common market*] "*would nourish unceasing animosities, and not improbably terminate in serious interruptions of the public tranquility,*" Madison, Federalist Paper No. 42) but also stressed the inherent free-rider problem between the states. They argued that without special institutional arrangements that would delegate all aspects of trade policy to the federal level, inter-state trade barriers are bound to emerge in equilibrium. In Federalist Paper No. 42, James Madison wrote:

> "The defect of power in the existing Confederacy to regulate the commerce between its several members, is in the number of those which have been clearly pointed out by experience."

[2] By state capture, we mean a high degree of dependence of public policy on special interests. For the theoretical applications of the interest group politics to Russia, see Glaeser, Scheinkman and Shleifer (2003) and Sonin (2003); for the empirical evidence on state capture in Russian regions, see Slinko, Yakovlev and Zhuravskaya (2005).

[3] Article I Section **8** of the Constitution of the United States of America, also reinforced by Article I Section 10.