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Abstract

In theory fiscal decentralisation is seen as a way to overcome informational constraints and opportunistic behaviour in a political system. It can increase accountability and the efficiency of the public sector thus improving the quality of governance and enhancing economic growth. However, empirical and theoretical studies of decentralisation suggest that the positive effects associated with fiscal decentralisation heavily depend on the institutional structures governing intergovernmental relations. Since in practice decentralisation is often the outcome of an intricate political process, the evolving institutional structures can limit efficiency.

Indeed, the decentralisation process in the Russian Federation has been rapid, uncoordinated and largely non-transparent, with the emerging institutional system of intergovernmental relations limiting economic efficiency. Decentralisation has been taking place in a complex environment and was pulled and pushed by a multitude of factors. The problems intertwined with intergovernmental relations include the recent history of disintegration of the Soviet Union; the ongoing violent conflicts in Chechnya; the ethno-linguistic, religious and historical differences across Russia's vast territory; great variations in the endowment of mineral resources; increasingly large economic and fiscal disparities across regions and local governments.

This political complexity has resulted in a malfunctioning system of intergovernmental relations. The paper argues that various aspects of this system have created adverse incentives for sub-national governments. For most of the 90s sub-national governments faced weak fiscal incentives for responsible budgetary management and the adoption of policies conducive to entrepreneurship, fair competition, and the development of new private firms. This is reflected in the poor climate for business and investment, excessive entry barriers, licenses, fees, taxes and various types of extortion imposed by regional and local governments. Moreover, the concentration of a significant share of federal transfers in regions with rather conservative economic policies has -while smoothing income disparities- contributed to the persistence of gaps in the economic base of regions and helped to delay restructuring. Beside the incentive problems deriving directly from the institutional design of the fiscal system another important factor certainly contributing to its malfunctioning is that sub-national governments have been captured by special interest groups. Colluding with large enterprises many regions have engaged in evading the payment of federal shares of tax revenues in order to increase share remaining within the region in particular by the extensive usage of barter and money surrogates.

Hence, regional governments generally contributed to stagnant growth and persisting governance problems, e.g. inefficient tax collection, lack of economic restructuring, barter and arrears in Russia in the 90s. Decentralisation, while certainly benefiting some regions and enterprises, created externalities for the country as a whole, that undercut any potential economic benefits that it might be expected to deliver.

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I. Objective and Organisation of the Paper

This paper examines trends in the development of intergovernmental relations in the Russian Federation during the period of economic and political transition with particular emphasis on the dynamics of simultaneous political, administrative, and fiscal decentralization. Specifically, the interactions between the institutional design of the federal system and the state's performance in the provision of public goods and enhancing economic prosperity will be explored. The paper provides evidence how the evolved structure of power and resource sharing between the different levels of government affects the state's incentives to foster business growth and to provide public goods efficiently.
The institutionalisation of relations between the different levels of government, i.e. the federal state, the 89 subjects of the federation and the about 30.000 local governments has been one of the most contentious aspects in the process of building the post-soviet Russian state. The development of intergovernmental relations has been taking place in a complex environment and was pulled and pushed by a multitude of factors. The problems intertwined with intergovernmental relations include the recent history of disintegration of the Soviet Union; the ongoing violent conflicts in Chechnya; the ethno-linguistic, religious and historical differences across Russia's vast territory; great variations in the endowment of mineral resources; increasingly large economic and fiscal disparities across regions and local governments; and the spreading sentiment in some regions that they can be better off by seceding from the Federation. Against this background the decentralisation policy in the last decade has seen ebbs and flows from provincial revolt and central laissez faire after the Soviet collapse, to central assertiveness in Chechnya and beyond, from federal atrophy under Yeltsin's second term to a renewed drive to re-centralize under Putin, who as one of his first acts in office initiated a reorganisation of federal relations and proposed a series of law designed to reinforce the central authority in the regions.
Although the paper will not be able to address the whole complexity of the outlined landscape it will put forward arguments that the inefficiency of institutional arrangements responding to this complexity - in particular a malfunctioning system of fiscal federalism - are possibly important reasons why Russia lags behind other countries in economic growth.[1] It will thereby focus on the period of Yelzin's presidency; though the most recent changes introduced by Putin's tax and administrative reforms will be touched upon briefly at the end of the paper.
The paper is organised as follows. The first section will consist of a theoretical part reviewing recent relevant theoretical literature. The major findings of the debates on the interaction of institutions, governance, decentralisation and economic performance will be operationalised in the context of post-soviet transition.
The second section will focus on the Russian case. What are the relevant institutions, the informal and formal rules of the game that form intergovernmental relations and regulate the behaviour of actors within the federal structure of the Russian state? What are the repercussions of simultaneous political and fiscal decentralisation for the efficiency of the institutional design, resource mobilization and allocation, service delivery, and equity? What incentive effects arise from different institutional designs of the decentralised governance system?
A conclusion embracing the major finding will be given in the last section. From that policy options and reform recommendations will be drawn.
In terms of methodology the chosen approach is rather qualitative. The paper will employ the relevant theoretical and applied literature, in both English and Russian language. Though qualitative in nature, it will make use of statistical data from different sources to enrich the argument in places.[2] Although the paper mainly focuses on the Russian case the global relevance of the issues at stake make a wide range of comparisons with other post communist states as well as with developing countries not only possible but very fruitful.

1 A number of studies have identified the current federal system as a major obstacle to successful economic transition. For example OECD (2000b), Shleifer and Treisman (2000), Stoner-Weiss (2000).
2 The sources will be specified there and then.

II. Theoretical Framework: An Institutional Approach to Governance, Decentralisation, and Economic Performance

The interactions between governance, decentralisation, and economic performance are increasingly popular in debates on public policy, reform, and development policies. Consequently, the debate on these issues is broad and varies greatly in terms of academic disciplines and traditions, different assumptions and objectives. The following section will outline a theoretical framework drawing on recent neo- institutional approaches. Though, it mainly employs insights from the politico-economic branch of institutional theory, there is awareness of the considerable literature on institutions in other disciplines, mainly sociology.

1. The State, Institutions and the Market

The concept of governance used in the context of this paper broadly refers to the traditions and institutions by which authority in a country is exercised. The World Bank defines governance as "the manner in which power is exercised in the management of a country's economic and social resources."[3] That includes the capacity of the government to effectively formulate and implement sound policies, the power to redistribute a share of social wealth through taxation and public spending as well as mechanisms that ensure the accountability and transparency of the public sector, the process by which governments are selected, monitored and replaced, and the respect that citizens and the state have for the institutions that govern economic and social interactions among them.

What makes the centralised exercise of authority through the state necessary in a market regulated economy, in which the invisible hand is supposed to allocate goods and services efficiently? Political economists have developed explanatory theories of the state deriving its role from market failures.[4] The price mechanism leads to Pareto optimal allocation only under the conditions of perfect markets when no informational constraints and property rights are clearly delineated, e.g. when transaction costs are marginal or zero.

Yet, it is well known that the market mechanism can fail or lead to undersupply in cases of (positive or negative) externalities in production or consumption, public goods or "bads", and information and transaction costs that make the spontaneous emergence of some markets difficult. Externalities arise when the action of one actor hurts or benefits others without that actor paying or receiving compensation.[5] However, in cases of externalities the social costs can be higher than the benefits of the individual actor causing them and thus, the spontaneous market-led way of operating would not be consistent with Pareto-efficiency. To put it in a more general form: Laissez faire can not deal efficiently with externalities and public goods, because there is no linkage between any individual payments or income losses to obtain collective goods and the enjoyment of these good. Thus, public goods would not in general be adequately provided. To cite Stiglitz: "Adam Smith's hand may be more like the Emperor's new clothes: invisible because it is not there".[6]

The standard institutional approaches envisage externality or public goods' problems, uncertainty and unequal distribution of information among actors and free-rider problems as obstacles, which can hinder cooperation even in situations, in which the possible payoffs rewarding mutual cooperation are relatively high (the famous Prisoner's dilemma is the game-theoretic micro-foundation of this assertion).[7] Institutional arrangements are the

3 See World Bank 1997 p. 302.

4 The intention of these theories is however not to explain the historical emergence of concrete states, but rather to develop a underlying rationality which can be used to understand the role played by the state in modern economies. The basic logic has been combined with evolutionary theories arguing that some states might turn out to be more stable in a evolutionary process by raising the citizens acceptance and fostering economic development. See Harder (1995)

5 Pollution through industrial production that imposes social costs on the society is the most commonly used example for a negative externality, the broader benefit to firms of a literate population is a positive externality of primary education. That translates into pollution being a public bad and less of it being a public good, and vice versa for the example of primary education. The pathbreaking work of Mancur Olson is considered to be the first to develop a consistent theory of public goods and how problems in their delivery can be overcome. See Olson (1964).

6 Stigliz (1991, p. 12)

7 Transaction costs consist of the costs of measuring the valuable attributes of what is being exchanged and the costs of protecting rights and policing and enforcing agreements. A huge part of the literature on transaction cost in institutional economics descends from the milestone writings by the Nobel laureate, Ronald Coase. In his article on "The Nature of the Firm" Coase argued in late 30s of the last century, that the reduction of transaction

means for achieving and sustaining cooperative equilibria among actors, under the set of conditions, referred to as market failure or collective dilemma.[8]

According to the very broad concept of Douglass North institutions are “the rules of the game in a society or, more formally, the humanly devised constraints that shape human interaction”.[9] Institutions define and limit a set of choices of individual behaviour and thus allow people to form stable expectations in human exchange, whether this is social, economic or political exchange. Institutions are both formal rules (constitutions, laws, contracts) and informal rules (traditions, customs, conventions and codes of behaviour). Institutional structures - such as the institutional configurations of the government - shape the goals, opportunities, and actions of the groups and individuals operating within it. They both enable and constrain behaviour. The institutional system in a society regulates and coordinates the exercise of authority by setting up incentive schemes and commitment mechanisms in order to overcome informational constraints, internalise externalities, and provide public goods, services or information. It is intuitively clear that, the increased complexity of market relations in an industrialised society demands for a more formalised institutional system because traditional institutions such as trust and community reputation become less effective since most of the exchange is based on impersonal bases.[10]

Under those conditions the state becomes a key player in establishing such an institutional environment conducive to economic development. Besides guaranteeing basic public goods such as territorial integrity and physical security, the conditions necessary for an effective exercise of citizenship the state must fulfil a multitude of more complex tasks. If economic development is to be sustained the state must provide important institutions including those defining norms of behaviour, reliable information, commitment mechanisms, property rights, auditing systems and effective law enforcement. The state must mobilise public savings, rectify resource allocation and income distribution, and provide macroeconomic stability. Clearly, without an effective state there can be no market.[11]

However, public and academic debates in the last decades have seen an increasing suspicion about the state’s role in the economic realm. This was mainly catalysed by two major developments: the fiscal crisis of Keynesian welfare states in most of the established industrial countries and the break-down of the state administered socialist economies. Evidently, the public sector in many countries has become too large, politically sluggish and economically inefficient. From a theoretical perspective neo-liberal scholars have highlighted, that the very capacity of the state to engage in productive activities and to favour private projects differentially causes rent seeking and market distortion leading to sub-optimal outcomes.[12] In a neo-liberal world political intervention in markets is the outcome of a predatory tax revenue-maximising state that limits economic choices of individual market agents and creates disincentives for innovation and long term investments. Such a predatory state is inconsistent with economic development because it discourages productivity and leads to misallocation of resources.

While these dangers are real and commonly agreed, the neo-liberal answer calling for major political deregulation and prevention of discretionary intervention by the state is simply insufficient. Indeed, the weakest point in neo-liberal prescriptions derived from standard neoclassical models is that they underestimate the role of state institutions in organising both the public and the private life of groups and individuals. On similar grounds the neoclassical bias of the last decade’s reform programs based on the Washington Consensus has experienced devastating critique.[13] As Phil Hanson argued: “By mid-1999 the results of the whole transformation attempt could best be described as messy. The scale and character of the mess had not been anticipated by orthodox economic theory.”[14]

On the contrary the institutionalist approach used in this paper overhauls the language of the state versus the market.[15] Neither can problems of institutional design be avoided by throwing the state out of the economy nor will state institutions under all circumstances lead to socially optimal outcomes. Markets and governments are complementary and for both it is essential to have in place appropriate institutional foundations. The state in a market economy faces - like complex organizations in general - informational constraints, externality problems,

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costs is the rationale beyond the integration of production and activities within hierarchical firms and contractual networks. In principle all those activities could be coordinated by markets, but then transaction costs would be much higher. This argument has been extended and generalised to more general analyses of institutional arrangements. For example North argues, that governments can also be understood as institutions that can reduce transaction costs. See North (1990a)

8 See North (1990), Eggertsson (1990).

9 See North (1990).

10 See North (1990).

11 See World Bank (2001) in particular Chapter 5.

12 See Stigler and Cohen (1971) and Buchanan (1980).

13 See for example Murrell (1992).

14 See Hanson (1999) p. 2.

15 Hall and Taylor (1996)

and transaction costs that offer many chances for opportunistic behaviour.[16] Information advantages and externalities limit efficiency by giving rise to socially costly opportunistic activities of various kinds. Thus, for a governance system to function properly, it is necessary to address a host of underlying externality problems that distort incentives for individual actions and ultimately lead to poor outcomes.[17] To cite Joseph Stiglitz again: "[…] misaligned incentives can induce government officials to take actions that are not, in any sense in the public interest."[18]

A complex governance system can be conceptualised in terms a multiple agency relationships between managers and employees, owners and managers, creditors and entrepreneurs, citizens and politicians, politicians and bureaucrats.[19] The general idea is that the interests of the parties in a transaction are at least partially in conflict, and the agent has some action or information advantage over the principal. In the standard model of operation of an agency the principal devises a scheme of incentives or penalties, in a way that the agent's action is altered at least partially in the direction that favours the principal's interest. The performance of the state and of the private sector and of the economy as a whole depends on the design of institutions that regulate these relations. In fact, an effective governance system is a question of specific mechanisms that would provide particular agents including the state itself with incentives and information that would lead them to behave in collectively rational manners. The institutional design of any country's political system determines whether government officials face incentives for good or bad governance.

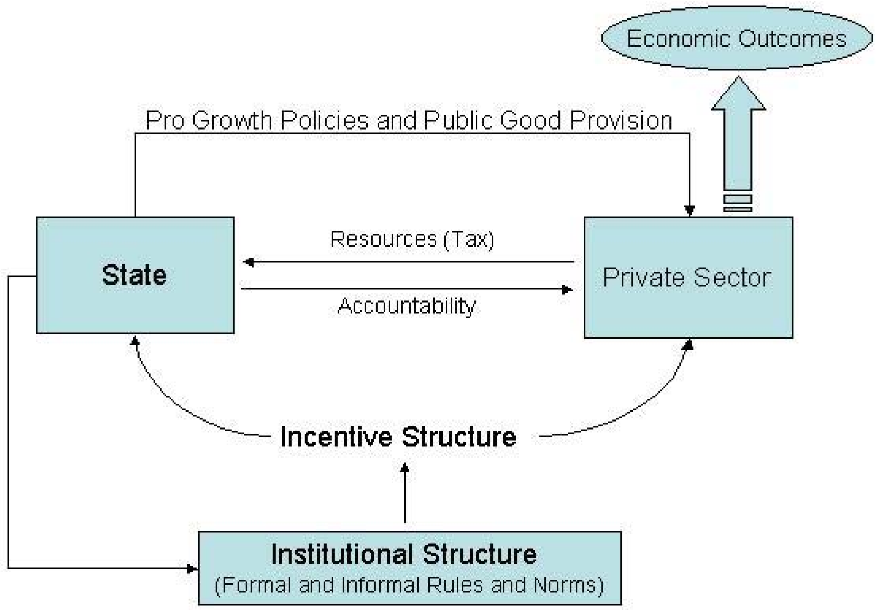
16 Opportunistic behaviour ensures that each exchange partner will attempt to turn future contingencies to their benefit, even at expenses of the other. Opportunism means people are self-interested with guile. This includes both simple forms like lying, cheating and stealing, and more subtle forms like calculated attempts to mislead and distort. The internalisation of transaction costs in rational calculations is the very source of institutional structures. Eggertsson (1990) describes institutions as agreements about a structure of cooperation that reduce transaction costs, opportunism, and other forms of "slip-page".

17 See Hardin (1995).

18 See Stiglitz (1998), p. 5.

19 Agency relationships in the political sphere are complex. First, it is not always clear who the agent is. Politicians are agents of voters, public administrators are agents of politicians, etc. Second, politicians and administrators are subject to capture by interest groups, which may not seek to maximize social welfare. Politicians must be given incentives to seek social welfare as they have their own objectives and are not perfect agents for voters.

Fig. 1 Governance, Institutions, and Economic Outcomes



This argument is particularly critical in the transition environment.[20] As Shleifer and Treisman argue: "[…] changing polices […] often calls for a restructuring of both political and economic institutions, while reforming institutions often requires appropriate government policies and political strategies."[21] Clearly, if state institutions are to be capable of performing their tasks efficiently, they must be reorganised, rather than simply reduced.[22]

In order to understand how institutional constraints and opportunities are manifest in the transition societies, they must be placed within a historical process in which timing, unintended consequences, learning, and policy feedback matter. In the context of regime-transition political and economic agents face institutional arrangements, which seem to be less durable and constraining.23 Institutions, constitutional principles, informal rules, codes of conduct and even more basically the borders of political units still are in flux and tend to be more fragile. In many instances the institutional structures are themselves endogenous to the bargaining process among political players and should thus be taken as dependent rather than as independent variables.

However, since the impact of institutional reforms often takes the form of a non-linear effect over time, with reforms initially causing a decline in growth rates the creation of new institutional arrangements often involves a trade off between short term costs, presumably due to adjustment costs, and long term benefits. Political players may thus face incentives to stick to existing institutions. This is particularly likely if the improvements from pro-growth policies take a long time to materialise, and the incumbent politicians are unlikely to benefit from them.

Additionally, distributional interests of powerful private stakeholders may oppose some institutional reforms.[24] They may thus be politically undesirable, because likely losers are part of the support basis of the political elite. The distributional effects of a certain reform and the political strength of key groups (particularly those that will lose) turn out to be critical factors in institutional change. As the Nobel Price Winner J. Buchanan summed up

20 See EHRD (1999).

21 See Shleifer and Treisman (2000).

22 It was shown for the history of many societies efficient institutional arrangements and their enforcement are a economic growth enhancing public good. But as was argued by other authors special interest groups and distributional coalitions may lead to sub-optimal institutional equilibria depressing economic growth and causing high social costs. See Bradhan (1988) and Hellmann (1997) and Olson (2000).

23 See Shepsle (1986).

24 This is consistent with Hellmann (1997), who develops a political economy of partial reform in which winners of partial reforms use their immense political influence to hinder further reformation in order to sustain their rent seeking opportunities. On a more theoretical level it seems to be reasonable to model the Russian governance structure as an institutional setting that is characterised by the nature of a Nash equilibrium rather than by Pareto optimal conditions.

the collective dilemma of political reforms, “the only way to conduct a balanced reform is to make everybody take their hands out of everyone else’s pockets simultaneously”.[25]

2. The Costs and Benefits of Decentralised Governance

The discussion of public goods, externalities and transaction costs has demonstrated that the spontaneous market does not lead to Pareto optimal outcomes under all circumstances. However, as we have seen, this does not yet imply that the state would do it better. We still need to explore the role of institutional design with regard to the governance system. The question of how to organise state institutions so that they would engage in socially efficient and beneficial activities becomes the main concern.

One important structural feature of any governance system is the decree by which it allows for a decentralised exercise of authority. There is a long tradition in political economy that emphasises the benefits of decentralisation for good governance.[26] More recently, there has been extensive theoretical groundwork and empirical research, which explores the relation between decentralisation and economic performance.[27]

At the same time, political systems in many countries have witnessed a redistribution of property rights and bargaining powers among levels of government in recent years and decentralisation is widely perceived as one of the defining trends of contemporary global political life.[28]

In general decentralisation can be seen as a way to overcome informational constraints and opportunistic behaviour in a political system. It can increase accountability and efficiency of public services thus improving the quality of governance. It is supposed to bring authorities in more direct contact with citizens and rightly or wrongly envisaged as a way to resolve the tensions arising from the unequal pace of growth and improvement in standards of living in different regions of the same country. A key argument of traditional theory of federalism is that the benefits of decentralisation are positively correlated with the geographic, cultural and socio-economic variance in demands for public goods. Since central governments in larger, more heterogeneous societies such as Russia will find themselves faced with divergent preferences over redistribution societal resources or the provision of public goods political decentralisation should improve the quality of governance. [29] There is a political difficulty in aggregating preferences since a large population is statistically less homogeneous. Beyond a certain size, there can additionally be significant coordination problems and informational constraints. Naturally following from these arguments it is assumed that democracies should be more decentralised than authoritarian systems.

Additionally, more recent literature stresses the importance of governance structures and the government officials’ fiscal and political incentives to promote economic growth. Barry Weingast et al. identify a special type of federalism, *market-preserving federalism* that encompasses a set of conditions that governs the allocation of authorities and responsibilities among different levels of government allowing sub-national governments to experiment with specific economic policies.[30] According to the concept the following five conditions have to be addressed by institutional design of intergovernmental relations:

- a well defined federalist system (a hierarchy of government with clearly delineated scope of authority);
- a high decree of regulatory authority of sub-national governments in their jurisdictions;

25 Buchanan (1980).
26 Oates (1972), Tiebout 1956, Musgrave (1959). For modern reviews see Rubinfeld (1987) and IRIS (1999).
27 North and Weingast (1989), and Weingast (1995) relate a concept of "market-preserving federalism" to the historical period of rapid growth in Great Britain and the United States, while Monitola, Qian and Weingast (1995) and Parich and Weingast (1997) apply this concept to the cases of China and India.
28 This is in particular true for developing and transition countries. Nearly all large Latin American states have embarked on some form of decentralisation policy in the last decade, some beginning much earlier. China’s transition from socialism largely being a economic success story involves various aspects of decentralisation. India and Indonesia have very recently begun to promote decentralisation. See Globalisation and decentralisation.
29 This line of argument implies that excessively centralised systems in large, diverse countries will face overwhelmingly pressure to decentralise and danger to fall apart through secession or civil war. Based on those assumptions a key argument of traditional fiscal decentralisation theory is that the benefits of decentralisation are positively correlated with the geographic variance in demands for publicly provided goods. See Musgrave (1959) and Oates (1972). Consistent with these theoretical assumptions Panizza (1999) finds cross country empirical evidence that decentralisation is positively correlated with country size and ethno-linguistic heterogeneity.
30 See also Oi (1992), Oi (1994), Montinola et. al. (1995), Qian and Weingast (1996), Qian and Weingast (1997), and Jin et. al. (1999).

- the central government has a recognised authority to enforce the common market and the absence of barriers to trade and factor mobility;
- revenue sharing and borrowing is characterised by hard budget constraints;
- the allocation of authority has an institutionalised degree of durability that cannot be altered unilaterally or through a coalition of governments.[31]

If those conditions are met federations foster a virtuous competition among jurisdictions for taxes and investment. Jurisdictions compete through taxation policies, expenditure, and regulatory policies for mobile firms: They try to attract firms both for the wage income they create and the tax revenues they provide. Competition among governments in this framework is efficiency enhancing and federations create an institutional environment conducive to economic growth.[32] From this perspective, levels of decentralisation are viewed as long run efficient responses to demands made by investors and voters.

However, decentralization is not ipso facto an accountability mechanism but also bares considerable risks. In contrast to the above noted arguments are in fact, both empirical evidence and economic theory that cast doubt on the general assertions about decentralisation and economic development. Recent cross-country empirical analysis of the relation between decentralization and growth in developing countries found a negative correlation between these two variables.[33] Theoretical scepticism has been uttered on the assertion that several externality problems deriving from common pool problems, inter-jurisdictional spill-overs, and soft budget constraints can result in efficiency losses associated with decentralisation.[34]

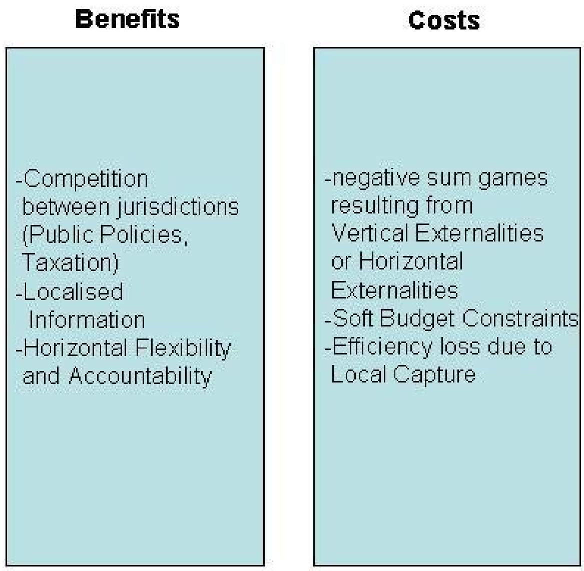
The standard tragedy of the commons problem emerges if more independent tax agencies share the same tax base.[35] One consequence of overlapping tax bases is that the tax rate set by each level of government creates “vertical externalities” by reducing the tax base of the other level leading to an equilibrium with an excessively high aggregate tax rate, reduced aggregate tax collections, deficient provision of public goods, low investment and low output.[36] This is consistent with the argument developed by Shleifer and Vishny (1993) who show that decentralized corruption is a kind of free-for-all, because those who are taking bribes do not take into account the externalities of their own actions on the other potential recipients of bribes whereas centralized corruption has a stake in not killing the goose that lays the golden eggs.[37]

Another danger is that sub-national governance falls under the sway of vested interests, leading to misallocation of resources and costly market distortions. In their comparison of the delivery of local public goods under decentralized and centralized modes of governance Bardhan and Mookherjee show that if local capture by powerful interest groups is distorting resource redistribution, decentralization may be worse from a welfare point of view, even when local agencies have more information about costs and the needs of the population. [38] Capture of democratic processes by special interest groups may depend on different factors such as the electoral system, media landscape etc., but foremost on the relative bargaining power of special interest groups which most directly reflects their ability to use the political process to their advantage. Most importantly, the size of an enterprise relative to the total tax base and number of employees relative to the population translates into resources to fight off tax collectors or to lobby for subsidies. Taking into account those factors it comes as no surprise, that local governments often appear more vulnerable. Since they are smaller relative to large firms, and more directly affected by the unemployment implications of the closing a particular firm, it is more likely that

31 See Weingast (1995).
32 On the the linkages between decentralisation and economic growth see Martinez and MacNab (2001).
33 These results hold for a cross-country model estimated for 46 developing countries (Davoodi and Zou, 1998), and cross-country model for developed and developing countries (Fukasaku and De Melo, 1997).
34 (Rose-Ackerman 1997) and Shleifer and Vishny (1993). There are both vertical and horizontal externalities. The more familiar “horizontal externalities” caused by spillovers, tax exporting etc are reviewed in Inman and Rubinfeld (1996). Bird (1999) gives an overview.
35 See See Berkowitz and Li (1999) and Bird (1999).
36 Competition between the various layers may lead to tax rates that are too high (the argument is similar to the industrial organization literature on vertically differentiated monopolies, which set prices too high to maximize their joint profits). If tax rights are thought of as the property rights that a government appropriates over its own tax base, then the essence of tax rights is the right to exclude. Thus, a government's tax rights are poorly defined when it and other governments and agencies can unilaterally levy taxes on the same tax base. See Berkowitz and Li (1999).
37 Empirically this has been underpinned by Treisman (1999) who, using data from a large sample of countries in the mid-1990s, examines the question why federal states are perceived to be more corrupt.
38 Bardhan and Mookherjee (1999).

they respond favourably to requests for transfers or protection. Indeed, under those circumstances, federalism may actually strengthen "distributional coalitions" that may impede growth.[39]
The

Fig. 2: The Costs and Benefits of Decentralised Governance



outlined dangers show that federalism does not unleash any systematic tendencies with respect to good governance and growth. If it creates incentives for disintegration and does not constrain costly opportunism, decentralisation can come at the cost of a weakening of the overall capacity of the state. Clearly, the devolution of political power could end up in fiscal disorder and economic stagnation, enhancing the welfare of some provinces only at the expense of others. Thus, the central government will always play a vital role in sustaining development and economic prosperity. There are certain public goods, which are more efficiently by centralised control.[40] Besides, central government intervention is frequently needed to help lower level jurisdictions to cope with spill-overs, problems of coordination, and resource shortfalls. The central government has to establish and ensure the internal common market as a single economic and legal space by guaranteeing the unrestricted flow of capital and people across provincial borders. This includes the general regulation of markets, the establishment of standards, and other infrastructure as well as the maintenance of political stability against external threats and internal social tensions.[41]
Thus, the challenge is to find the right division of labour between the centre and lower levels of government. The governance outcomes of decentralization depend in large parts on the design of a policy mix including fiscal, administrative and political decentralisation. This includes not only the design of institutions regulating intergovernmental relations but the overall capacity of the political system to align the interests of national and regional politicians and to facilitate collective action among them. If the federal government lacks independent resources to impose and sustain collective equilibriums the incentives especially for economically robust regions to pursue regionalist policies are high and federations develop latent tendencies to fall apart. In his classic comparative study of federalism Riker (1964) suggested that federations are kept together by a system of incentives for regional politicians that maintain their loyalty to the state as a whole rather than to one region.[42] In

39 For some evidence fro the Russian case, see Kirkow (1996).
40 This applies for goods , where economies of scale or interjuridinctional spillovers are present on the supply side or where minimum standards and other consumption externalities (education, political stability, market size) exist on the demand side.
41 Another important national policy consideration in countries where sub-national governments have independent taxing power is to ensure an adequate degree of internal tax. See IRIS (1999).
42 Riker drew a sharp analytical distinction between explaining the origins of federal systems and analyzing their survival. For Riker, federal systems invariably emerged in response to some external threat or opportunity, but they could survive in the face of a radical change in the external environment. In Riker's theory, a federation develops out of a "bargain between prospective national leaders and officials of constituent governments for the purpose of aggregating territory, the better to lay taxes and raise armies" (p. 11).

his analysis the critical ingredient is a national party system that by promoting career paths of individual politicians and by providing administrative or electoral support creates integrative incentives.[43] Consistent with this approach Blanchard and Shleifer in their comparison between decentralisation in China and Russia argue that the net effect of decentralisation heavily depends on the political context, which is a parameter in their model. They conclude: "[…] the economic benefits of decentralisation obtained from federalism rely crucially on some form of political centralisation."[44]

III. Intergovernmental Relations, Institutional Choice, and Decentralisation in the Russian Federation

This section will address the problem of intergovernmental relations in the Russian Federation from the theoretical perspective outlined above. The section is organised as follows. A first part will give a brief introduction that places the problem of this paper in the broader context of a decade of post communist transition in Russia and argues for the relevance of the proposed research question. The second part will describe the political dynamic and the evolution of centre periphery relations in Post Soviet Russia. The third part will turn to the institutional foundations, both formal and informal, that regulate intergovernmental relations in today's Russia. Particular emphasis will be put on the system of fiscal federalism and on the incentive structure created by its institutional foundations for lower ties of government.

1. Governance and Economic Growth in Russia

The last decade has seen a wide variation in economic performance across the countries in Eastern Europe and Asia that have embarked on economic reforms. By comparison with the significant and continued growth in countries such as Poland or China, Russia's record of economic performance has been fairly disappointing. GDP growth rates were negative every year from 1989 - 1997. Consequently recorded GDP in real terms was halved between 1989 and 1997 and despite the ongoing recovery after the major economic crisis of 1998 the level of output in 2000 was still below a quarter of the pre-transition level in 1990.[45] Gross fixed investment in Russia has even been more rapidly decreased than output, lowering its share of GDP from 28.7 percent in 1990 to 18.8 percent in 1997, and is only slowly recovering.[46]

How come that the attempts to create a market economy in Russia after 1991 have had comparatively poor outcomes? Much literature has appeared in recent years to explain this variation, most of which concludes that three sets of explanatory factors play a role in explaining the differences in performance across the transition countries: initial conditions, international environment, and the quality of governance.[47] However, there is a considerable debate about the relative importance of the different variables, for example reform policies versus initial conditions. While there is general agreement that different starting points are important for economic performance, particularly during the first years of transition, the case has been made that the relative impact of initial conditions is rapidly declining over time.

Accordingly, most of the more recent papers have focused the debate on structural reforms, institution building, and more generally on the quality of governance.[48] It has been widely recognised that one of the crucial

43 Ordeshook (1996) places a similar stress on the integrative role of parties.

44 See Blanchard and Shleifer (2000), p.11.

45 Following the financial crisis of 1998, the Russian economy has experienced its first serious growth in ten years of transition. Growth of 3.2% in 1999 has been followed by 6.5% growth in 2000. However, the general view is that growth will peter out unless reform measures can transform advantageous short-term factors into longer-term sustainability. See Ickes and …The World Bank estimates the recorded GDP 1990 with 1.100,1 Bill US$ and the GDP 2000 with 251,1 Bill US$. See Worldbank "Russia at a Glance", 2000.

46 See EBRD (2001).

47 For a theoretical overview see World Development Report (1996). Recent empirical work on transition in the Former Soviet Union and Eastern Europe has analyzed explanations for differences in economic growth observed across countries. Several studies have emphasized the importance of stabilization. (Aslund, Boone and Johnson (1996); de Melo, Denizer and Gelb (1996); Sachs (1997)) and other liberalization policies (de Melo and Gelb (1996); Selowsky and Martin, (1997)). Others have emphasized pre-transition initial conditions (Blanchard and Kremer (1997); de Melo, Denizer, Gelb and Tenev, (1997)). Finally, Johnson, Kaufmann and Shleifer (1997) have emphasized the role of public finances and corruption.

48 An example is Joseph Stiglitz's (1997) influential work on the Post-Washington Consensus, which stresses that the government must complement the market. Stiglitz especially emphasizes government's role in human

preconditions for successful economic transition is to build institutions that support a market system. Such institutions range from bankruptcy laws and antitrust regulation fostering a competitive market structure, to rules defining property and contract rights. As argued above, the state is central to providing such a viable institutional environment conducive to economic prosperity. Low state capacity, a general lack of accountability and transparency in the public sector were found serious and mounting obstacles to further progress in most areas of economic and social policy.

In that vein many observers have repeatedly remarked on the weakness of the new Russian state - particularly relative to the overcrowded and complex political agenda it faces - and have identified “bad governance” as a main cause for the economic difficulties of Russia in the last decade.[49] Despite of remarkable achievements such as the control of inflation by restricted money-supply growth and the privatisation of most of the Russian enterprises, some pressing issues of governance remain unsolved.[50] Indeed, the state’s inability to prune public expenditure and subsidies effectively, to enforce contracts, or to collect taxes has pervaded the Post Soviet transition. The weak public financial system and sustained budget deficits constantly constrained the state in paying public sector wages and pensions on time or provide meaningful poverty relief. Due to effective lobbying and state capture by vested interests the state flinched at the same time from imposing hard budget constraints on large enterprises or large banks and thus postponed the restructuring of privatised enterprises and the banking system.[51] To sum it up: The job of reorienting the state toward the task of “steering, not rowing” is far from complete in the Russian Federation. As Mau concluded: “The fundamental feature of Russian post-communist reform is that they were implemented at a time of weak state power”.[52]

However, any profound assessment of Russian state strength or weakness needs more detailed research. Arguably, one of the most contentious issues in this context is the problem of decentralisation e.g. the redistribution of property rights and bargaining powers among levels of government. The OECD Economic Survey for the Russian Federation 2000: “The reform of fiscal federalist relations continues to be a critical, as well as a politically complicated, aspect of economic transition in Russia.”[53]

2. Russia’s Peripheralised Federalism

Before discussing issues of institutional arrangements regulating intergovernmental relations it is important to keep in mind that the structure of intergovernmental relations in Russia, as elsewhere, is not the sole outcome of a rational optimisation process. It has instead occurred in a politically volatile environment and a particularly eventful historical context.

The combination of simultaneous efforts aimed at consolidating a democratic political system combined with fundamental structural changes in the economy, strong centrifugal forces and political and ethnic conflicts in Russia in the early 1990s created an extremely complex setting for the establishment of a sound system of federalism.[54] In reality the evolution of the legal and institutional framework has been subject to fairly continuous change and reflects political compromise rather than consistently applied rules and principles. The current system of federalism can primarily be derived from the institutional legacy of the Soviet Union and a largely informal decentralisation process that has started as early as in the mid-1980s. The Russian Federation inherited the Soviet administrative division of the territory into 89 ethnically defined regions, the subjects of the federation. At the time of the founding of the federation each of these had its own budget and authority to legislate. The confusion created by the collapse of communism and the dismantling of the Soviet Union had been exploited by the regions to grasp significant shares of power.[55] Like in many other cases, in the Soviet

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capital development and in borrowing and creating new technology. For the Russian case Andreij Shleifer (1997) argues that the economic difficulties of Russia in the last decade can be explained in part by the government’s failure to provide institutions that promote business growth.

49 Shleifer (1997).

50 The emphasis on macroeconomic stability is consistent with the policy package offered by the Washington consensus and the efforts to control inflation were at least to same extent stimulated by the aspiration to restore Western financial assistance by trying to meet IMF loan conditions.

51 See Hanson (2000).

52 See Mau (2000), p.12.

53 See OECD p.24.

54 This is consistent with a theoretical model developed by Alesina and Spoalore (1997). They construct a model indicating how democratization might also lead to political disintegration.

55 Russian regions began playing an increasing role in resource allocation with the weakening of the branch ministries in the Soviet Union in the mid 80s. This process was accelerated by the collapse of the Communist Party and regionalisation was the formative development during the first wave of transition to market economy in the early 90s. The events are history:

Union and Russia regional elites have played important roles in the protests and negotiations that have led to regime transition. For regional politicians decentralisation was to a large extend an attractive political strategy to match their particular aspirations.
Consequently, central control has even eroded within federal bureaucracies - the police, the tax service, and to some extent the army and implementing central policies in the regions have generally required the support of the regional governments.[56]
Throughout the transition period the relations between the federal centre and Russia's 89 regional administrations have been characterized by extensive and protracted negotiations about the division of budgetary funds, natural resources, policy jurisdictions, personnel appointments, and other questions of fiscal and policy competence.[57] The main bargaining resource regional actors have to their disposal results from the fact that the centre faces the challenge of state building and constitutional bargaining in an environment of latent disintegration. Institutional arrangements were weakly enforced and in response to regional opposition and centrifugal forces, the federal government systematically offered advantages and privileges to regional governments in order to preserve the persistence of the federal state. The centre could however not countervail such a massive shift in bargaining power. Transition had come with emergence of a partly dysfunctional democracy reducing the centre's power and resources to reward or punish local administrations to impose its views. Since 1994 Republican and regional leaderships are subject to competitive elections, thus an important bound of control (job appointment) was replaced and the ability of the national government to reward or penalise incompliant governors has been very limited. The marginal role of national parties at the regional level and "party free" regional elections is another puzzle in the overall picture of Russia's extremely peripheralised federalism. Ordeshook and Shvetsova (1995) and Ordeshook (1996) argue that a strong, nation-wide party system is critical for establishing incentives for central and regional governments to cooperate with one another; they find that the party system in Russia lacks the necessary ingredients to support federal stability.[58] In the absence of effective federal instruments to monitor and regulate the behaviour of regional elites, regions have sustained great de facto regulatory and fiscal authority without serious constraints to potential regional opportunism.[59] Many regions have taken additional steps towards independence; these steps include the enactment of laws that contradict the federal code.
Clearly, today Russia's governance system manifests a hangover from this earlier drive for regional autarky and self-sufficiency, though recent years have witnessed recentralisation tendencies. As already mentioned, in the transitional environment the formal rules of the game are often contradicted by de facto political power. This also applies for intergovernmental relations that continue to suffer from chronically weak incentives and enforcement mechanisms creating severely defective structures and a lack of compliance with institutional settings. Politchuk's term of bargaining federalism (переговорново федерализма) captures this scenario.[60] Discretion, in the negative sense of opportunistic behaviour, characterises the relations among different levels of government. The real negotiations start after the contract is signed.

3. Fiscal Federalism

After having traced out the broader political dynamic of decentralisation policies in Russia, it comes as no surprise, that with respect to fiscal federalism both official legislation concerning fiscal relations as well informal practices circumventing these regulations have to be taken into account. The following chapters will thus deal with both formal regulation and the incentive structure they embed.

3.1 The Formal System

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56 In this game the centre needs to buy the support of regions in order to prevent the territorial integrity of the state. Similar argumentation can be found Solnik(1995).
57 See OECD (2000).
58 See Ordeshook and Shvetsova (1995) and Ordeshook (1996)
59 In all compound political systems constituent units will vary in population, ethnical homogeneity, resource endowments, geographical location (proximity to borders, etc.) and other parameters that can translate into bargaining power. Many of the jurisdictional privileges enjoyed by republics were based on the discretion of the central government, and the lion's share of those benefits went to three republics: Tatarstan, Bashkortostan and Sakha.
60 See Politchuk (1998).

Federal legislation delineates a three-tiered system, which consists of three levels: federal, regional, and local. Like in any federal system there are several technical and political questions that have to be resolved in the institutional framework regulating relations between the three levels. To follow Bird (2000) the most important questions are:

1. Who does what? – The question of expenditure assignment.
2. How is the provision of public goods of the different levels financed? – The question of revenue assignment.
3. How is any imbalance between revenues and expenditures of sub-national governments to be resolved? – The question of vertical imbalance.
4. How to compensate differences in fiscal endowments and public service provision resulting from fiscal decentralisation? – The question of horizontal imbalance or equalisation.[61]

The concept of market preserving federalism suggests that the institutions addressing those questions are crucial in the overall development of a market facilitating institutional infrastructure. Indeed, whether sub-national governments face incentive structures for good governance and growth-enhancing policies significantly depend on both, the way their budgets are financed and the scope they obtain for independent spending policies. Imbalanced assignment of expenditures and revenues results in overburdening of sub-national governments and leads to undersupply in public goods. Depending on their design, tax revenue assignments and transfer systems may spur fiscal effort at sub-national levels, but in doing so produce asymmetrical results and horizontal inequality that may be viewed as inequitable. On the contrary, transfer systems that do not make revenue-matching or other conditions part of their formulae may have greater equalisation effects but potentially run the risk for soft budgets and moral hazard.[62] To understand the impact of decentralisation on economic performance, it is necessary to look at differences in the structure of budget spending at the sub-national level because different combinations of investment, subsidies, and social spending have a different impact on economic growth.

However, the incentive effect arsing from fiscal institutions not only depends on how they depict power and revenue sharing but also on how durable the rules are over time. Governments face incentives to pursue growth-enhancing policies only if they anticipate a long-term stability of given institutional frameworks ensuring that their efforts are rewarded by future fiscal benefits.[63] Lower tier governments face no incentives to broaden the tax base and are not expected to engage in growth enhancing policies if they perceive that future fiscal benefits might be divested by the federal level.

3.1.1 Expenditure Assignment

The legal framework for expenditure assignments has been highly problematic throughout the transition period.[64] Neither the Constitution nor any other legislation has clearly defined the assignment of expenditure responsibilities in the Russian Federation. This resulted in overlapping and poorly defined roles and unclear divisions of power between the different levels of government.[65] Until very recently, expenditure activities of

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61 See Bird (2000).

62 For useful classification of different of transfer types and their likely fiscal and economic effects refer to Bahl (2000).

63 The reduction of tax rates to the welfare maxising point where society is most productive implies the same logic as long term investments. Much of the return is received long after the investment is made. The influence of instability of tax rights on governance performance is equivalent to the impact of insecure property rights on private saving and investment. If there is fear of expropriation there will be no investment and in the long run social wealth will be turned down. For very interesting thoughts about the implications of the time dimension for economic performance see Olson (2000).

* Martinez Vasquez and Boex (2001).

64 The problem of unclear expenditure assignments has been especially acute at the regional- local level, with regional governments enjoying a high decree of discretion over assignments to their subordinate local governments. See Martinez Vasquez and Boex (2001).

* Martinez Vasquez and Boex (2001).

65 During the Transition period only Articles 71 and 72 of the 1993 Constitution made explicit references to expenditure responsibilities, exclusively assigning some to the federal government while others are assigned

sub-national governments were regulated by a number of inconsistent federal laws with ad hoc changes implemented through annual budget laws. The closest attempt to delineate expenditure responsibilities more clearly is contained in the Budget Code, which was approved by the State Duma in 1998 and came into full effect in January 2000.[66]

Fig. 3 Expenditure Distribution by Function 1997(*

Expenditure	Federal	Regional
Administration and justice	62	38
Defense	0	100
Economic Promotion and Subsidies	21,6	78,4
Education	13,2	86,8
Health	11,8	88,2
Social Protection	41,3	58,7

In the early years of transition, in particular in 1992 and 1993, many responsibilities were transferred to sub-national levels of government. Consequently, the aggregated sub-national share in total government spending increased steadily and significantly from 23 percent in 1992 to 49 percent in 1999.[67]

Formal expenditure responsibilities assigned to the regional level include regional public administration, finance of regional organisations, housing subsidies, transportation and roads of purely regional significance. There are also parts of federal public administration that are co-financed by regional governments. Moreover, regions share a certain ambiguous joint responsibility with the federal government for major outlays such as education, health, economic subsidies and social policy, including salaries for workers of the social sphere. Figure 3 shows the respective shares of regional and federal budgets for certain expenditures for the year 1997.

In addition the cumulative impact of numerous unfunded federal expenditure mandates has significantly debited sub-national budgets. The history of unfounded mandates traces back to 1992 when the national government offloaded expenditure responsibilities for many social welfare programs onto the sub-national level to solve its own budget problems.[68] Although, since 1993, federal mandates without a specified source of funding have only a recommending nature, such mandates still account for a significant share of sub-national spending.[69] The government estimates that such mandates amounted to 600 billion roubles in 2001 or 8 percent of the country's GDP.[70]

The delegation of a majority of social expenditures to sub-national budgets has been highly problematic since it has not been accompanied by a similar decentralisation of formal fiscal authority on the revenue side of the budget.[71] The attempt to shift responsibilities, in particular on capital and social expenditures, onto sub-national governments has continuously increased pressure on sub-national budgets and has resulted in a significant vertical fiscal imbalance.[72] Thus, the fundamental problem in expenditure assignment, stressed by Christine Wallich in the first comprehensive study of fiscal federalism in Russia, remains acute: the lack of a legal framework regulating balanced assignment of expenditures and corresponding revenues.[73]

3.1.2 Revenue Assignment

According to the Law on Foundations of the Tax System of the Russian Federation (Articles 19-21) and the General Part of Russia's Tax Code, which became effective January 1, 1999, the main federal taxes include the enterprise profit tax, the value-added tax (VAT), excises on specific goods and raw materials, the personal income tax, the tax on extraction of minerals and natural resources, customs and state duties, and contributions

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jointly to the federal and the regional level. There are however no reposnibilties specifically assigned to the regional level.

66 The budget code, that contains two parts, and other relevant regulation can be found at www.budgetrf.ru.

67 See OECD (2000).

68 The problem of offloading budget problems is not unique for the Russian case. A discussion and cross country empirical evidence can be found in Rodden and Garret (2000).

69 Following the 1993 law a presidential decree stipulated that all mandates assigned to regional budgets without clarifying explicit sources of finance fort he respective budgets should only be of recommended nature. See OECD 2000.

70 See Nezavisimaya gazeta, 24 May 2001.

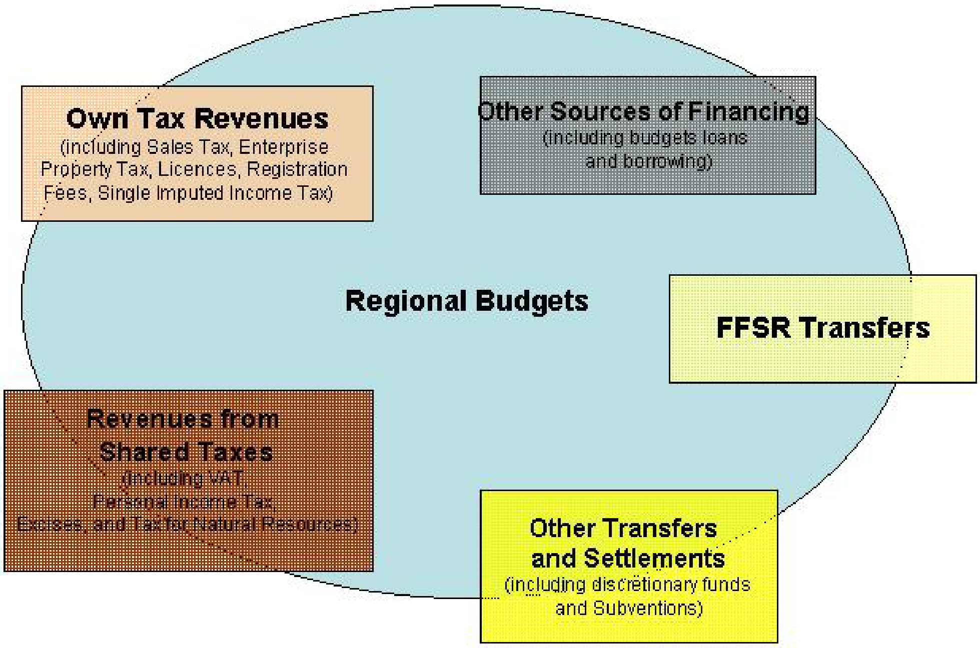
71 Among other things this concerned the function of paying salaries to the workers of the social sphere which was handed over from the centre to region without an according redistribution of tax revenues.

72 Imbalance between expenditure responsib ilities assigned to each level of government and the fiscal resources available to them to carry out those duties.

73 See Wallich (1994).

to state extrabudgetary funds.[74] Regional taxes include taxes on property of organizations, sales, real estate, roads, transportation; and regional license fees. Local taxes include the land tax, individual property, inheritance, and gift taxes, the tax on advertising and local license fees.[75] The revenue-sharing proportions between budget levels for each year, are stipulated by the annual Law on the Federal Budget. For 2002, for example, the government plans to assign 55 percent of all tax revenue collected in the country to the federal government, leaving 45 percent to the regions.[76]
Fig 4 shows the main sources of regional sub-national budgets. Although the relative importance of the different sources varies greatly from region to region, there are some common features with respect to the revenue side of sub-national budgets.

Fig.4 Revenue Sources Of Regional Budgets

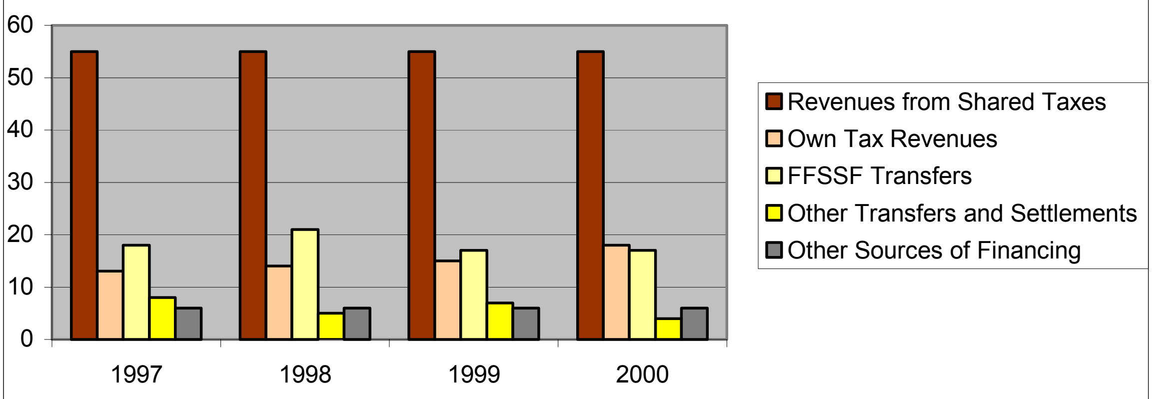


On the revenue side the vertical fiscal imbalance is mirrored in a lack of revenue autonomy at the sub-national level and the very limited role of own taxes in sub-national budgets. Although roughly half of all consolidated government revenue is assigned to sub-national budgets, less than 15 percent of sub-national tax receipts come from sources that could be considered autonomous in any real sense.[77] The major share, about 85 percent, of all sub-national revenues derives from federal fiscal transfers and four major federal taxes (VAT, Enterprise Profit Tax, Personal Income Tax, Excise Tax) that are shared on a derivation basis and neither regional nor local

74 The second part of the Tax Code, which became effective January 2000, renamed this tax the consolidated social tax.
75 For an encompassing overview over relevant regulation concerning the fiscal system in Russia please refer to www.budgetrf.ru.
76 The annual budget law was presented at a meeting on 23. May 2001. The distribution is the same as in 2001 and maintaining this distribution is one of the key goals of the Finance Ministry. Before Putin's reforms, the regions had controlled over 50 percent of the tax revenue and the regional leaders have complained bitterly about their loss of control over these money flows.
77 The new Tax Code of 1999 and 2000 reinforced these narrow limits of sub-national revenue autonomy. See Litwack et. Al. (2001).

governments have leverage regarding tax rates and tax bases of these taxes (See Figure 5).[78] Shared taxes will imply horizontal fiscal imbalances given economic disparities among different regions.[79]

Fig. 5 Composition of Regional Budget Sources*



Thus, the vast majority of sub-national revenues are not only determined by regulations of the national level but also come from taxes that are shared among different levels of government. Figure 6 shows the sharing rules for the major taxes for the 2001 budget. The federal government controls the tax rates and sets sharing rules of the major taxes on the basis of annual budget laws, with rates for the division of some of the leading taxes varying greatly from year to year in response to growing fiscal pressures. The federal government tends to make regular changes in tax sharing and to increase its share in main shared taxes. [80]

Fig. 6 Sharing Rates for 2001 Budget(*

Revenue Source	Federal	Regional	Local
VAT	100	0	
Excise	50	50	
(except excise for alcohol)			
Enterprise Income Tax	31.4	up to 52.4	up to 14.3
Personel Income Tax	1	99	

Another important component in intergovernmental fiscal flows are fiscal transfers of various types. Transfers are needed in order not only to maintain vertical fiscal balance (between levels of government) but also horizontal balance between units of government at the same level.[81] In any federal system in which same regions are rich and others are poor fiscal decentralization will result in growing disparities. In Russia, the fiscal gap between different regions has widened and resulted in growing disparities in public spending across regions: In

*OECD 2000

78 This limited autonomy of sub-national governments with regard to own taxes is to some extent a lesson learnt from the year 1994-1996, when regional governments were allowed to introduce own taxes, which apparently led to overgrazing of the tax base. See Shleifer and Treisman (2000).

79 Derivation basis means that the base for revenue is the amount of taxes collected within the boundaries of the recipient jurisdiction.

80 The single most important development throughout the transition period was the federal government's reclaim of sizable portions of the Excise Taxes and the Natural Resources Tax. While in 1992 the federal government received 47.9 percent of the Excise Taxes and none of the Natural Resources Taxes, by 1996 these taxes have raised to 86.8 percent and 25.1 percent respectively. See lists at www.budgetrf.ru

*www.bugetrf.ru

81 The initial economic disparities across regions and the uneven impact of the reform process on industrial sectors has led to a regional distribution of relative winners and losers of the transition process. Regional economic disparities of the Russian economy are partly inherited from the centrally planned Soviet economy. See Hanson (2000)

1992 Russia's richest spent 12 times as much per capita as the poorest, by 1999 the gap was 22 times.[82] Consequently, disparities in living standards and public good provision vary greatly across the federation. All documents on the state regional policy declare the necessity of levelling out the differences between the subjects of the Russian federation in the social and economic development and in the public welfare.[83]
While transfers account for only a quarter of sub-national revenue on average, in some regions they are the main source of revenue. According to Litwack et al 2001 federal transfers account for 50-60 percent of the budgets of the 20 least developed regions in Russia.[84] The design of transfers is of critical importance for the success of decentralization. The current Russian system of fiscal transfers is a mixed system of non-matching (lump sum) and earmarked transfers. It has three components. The most discussed are transfers from the Federal Fund for Support of the Regions (FFSR), which underwent a major reform 1998 aiming to increase transparency in federal transfers. Additionally, there are earmarked grants through federal projects and mutual settlements.
The FFSR is the largest component accounting for approximately 65 percent of all federal transfers. FFSR are block grants originally designed as formula-based system to equalise per capita budget revenues among the regions. The distribution of grants was based on revenue projections derived from previous levels adjusted to the current year.[85] A second form of transfers is earmarked financial assistance to the regions. These grants, which may be used for capital and current expenditures are determined by the Duma after negotiation between regions and the federal government. They account for approximately 15 percent of total funds to regional governments. The third component are mutual settlements which are used to balance the budgets of lower levels of government when deficits are created by changes in tax legislation and or adoption of federal laws prescribing new expenditure mandates. They include emergency grants, block grants, and settlements in lieu of financing regional investment programs and account for approximately 20 percent of total federal grants.

3.1.3 The Local Level

Intraregional budgetary relations, e.g. relations between regions and municipalities have not been the focus of the paper. However, they represent an important aspect which shall briefly be discussed in the following. According to Russian legislation, local governments have the right to create their own budgets. In practice, however, only half of Russia's 29,000 local governments actually enjoy this right. The situation differs from region to region: Most regional governments give local governments the right to create their own budgets but some do not. Additionally, the lack of independent budgets restricts the autonomy of local governments.
Intraregional fiscal systems are characterized by wide opportunities for the regions to decide almost unilaterally on specific arrangements for power and budget sharing with municipalities because the legal framework for fiscal federalism at the regional level is quite weak and regional authorities have full discretion not just for determining a desirable degree of centralization and redistribution of fiscal flows but also for frequently changing the rules of the game. Because of the high decree of discretion and soft adjustments between local and regional budgets some observers have concluded that there is in fact no local budgetary level.

3.1.4 The Tax Administration

A particular and important feature of the Russian fiscal system is the strong presence of federal fiscal agencies in the regions. Regional branches of federal tax authorities collect all taxes and transfer the majority of this revenue to the federal treasury, from where it is then reallocated to the budgets of the various government levels.[86] The federal tax police also maintains offices in the regions. According to the regulations salaries and running costs of these authorities are partly financed by the federal budget and their employees can be fired by their superiors in Moscow.
However, there is broad evidence that federal fiscal bureaucracies are informally captured by sub-national governments. Despite the fact that those fiscal authorities are subordinated to the federal level, they take orders

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82 See Boex and Martinez 2001.
83 See Programma (2000).
84 See Litwack et al. (2001).
85 See Martinez and Boex (1999).
86 The job of registration of taxpayers and collecting taxes is done by the regional offices of the Federal Ministry of Tax and Revenue. There are also regional offices of the Federal Treasury that deal with tax sharing and federal expenditures within the regions. The obligatory exception that proves the rule is the Republic of Tatarstan which maintains its independent tax service and treasury. Some regions however refer to usual regional financial institutions such as Central Banks or special authorised commercial Banks as treasuries.

from regional authorities. Martinez-Vasquez and Boex (2001) call this incidence dual subordination and derive the strong informal loyalty ties between federal tax service and regional governments from institutional legacy of the Soviet system. The Soviet Tax collection system out of which the Ministry for Tax and Revenue developed was a multi-levelled hierarchy of tax divisions of local and regional financial offices with multiple subordinations to local, republican and central authorities. As central control eroded, this system encouraged vast informal networking and collective resource skimming and collusion.[87] Regional branches collected taxes without remitting them to the centre. Though the establishment of Russian Ministry of Tax and Revenue formally replaced that system some of its engrained personal ties remained in place. The staff for the regional offices of the newly established Ministry was mainly recruited from members of regional administrative organisations. Since there has been no system of geographical rotation for officials and monitoring mechanism and hierarchical loyalty are only weakly enforced many tax administration officials respond to sub-national authorities.[88] These informal personal networks were cemented by economic dependence, because regional levels have increasingly provided logistic support, housing, office space or explicit funding to tax collectors in the regions. These arrangements affect the performance of tax collection and create the opportunity to withhold tax payments to the federal level and to hide locally generated revenue from federal confiscation. A prime example of this practise became public recently with the federal government making a concerted effort to limit the power of Bashkortostan President Murtaza Rakhimov over the tax police in his region. Until recently, the regional branch of the federal tax police was not only closely tied to the Bashkortostan Security Council but president Rakhimov also included the Head of regional branch of the Tax Police Engels Kulmukhametov, in the Bashkortostan cabinet of ministers. Kulmukhametov is also a member of the republican parliament even though federal law prohibits such membership for federal office holders of his rank. Additionally, Rakhimov provided the regional branch of the tax service lavish material aid. In exchange, the federal agency had turned into one of the main levers of Rakhimov's power. Using the tax police, Rakhimov was able to stream taxes and fees the tax police collected into the republican budget.[89]

3.2 The Outcomes of the System: Adverse Incentives and Informal Practices

3.2.1 Overlapping Tax Base, Vertical Externalities, and the Tragedy of the Commons

Shleifer and Vishny (1993) argue that the stagnation in Russia can be explained by the emergence of a chain of bureaucrats, each of whom can "hold-up" productive business activities by erecting a regulatory barrier in order to elicit bribes from would-be entrepreneurs. They have shown how such disorganisation and competition for rents lead to a much worse outcome than monopoly corruption from organised government.[90] A similar argument can be put forward for the formal system of taxation. Without a clearly delineated and enforced tax assignment, different levels of the Russian government could unilaterally impose additional taxes or raise tax rates on the same tax base.

This problem became especially acute in the years 1994 until 1996 when a temporary condition allowed regional and local governments to introduce autonomous tax and more than one hundred different types of local taxes and fees were levied.[91] The proliferation of seemingly irrational taxes - for example taxation of the use of foreign alphabets in company names - further complicated the already rather confusing tax environment. It was very difficult for reforms to keep abreast with all of the changes in the local, regional and federal tax code, especially

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87 See Martinez-Vasquez and Boex (2001).

88 Geographical Rotation of personell is employed by the U.S. internal revenue service.

89 Federal Tax Police Director Mikhail Fradkov's sought to cut the alliance between Rakhimov and the republican tax service. After meeting with Rakhimov on 3 July Fradkov announced new policies for the republican tax police. He planned to reduce the role of the group within the republican tax police that concentrated the tax police's work on collecting money for the regional budget. Fradkov said that the tax police needed to work in closer coordination with other federal agencies in the republic. Fradkov also sought to reduce the importance of the Bashkortostan Security Council, which currently coordinates the federal agencies in the republic. In its place, the Volga Federal District and the chief inspector for Bashkortostan would expand their role in coordinating federal agencies in the republic and monitoring the republican tax police. See Kommersant 5. July 2001.

90 See Shleifer and Vishny (1993):

91 A presidential decree "On theformation of the Republican budget of the Russian Federation and the relationship with the budgets of the Subjects of the Russian Federation" granted this right to sub-national governments. See Morozov, 1996.

since many of the changes were put into force retroactively. Enterprise managers frequently complained about the heavy burdens and complexities involved in paying taxes to many different governments. In 1997 the respective decree was put out of force, but many of the taxes were not abolished.[92]

While the formal fiscal autonomy of regional governments has been restrained since, the tragedy of the commons remains a problem with respect to pervasive informal practice and rent seeking. Overlapping tax bases and uncoordinated competition for tax revenues and rents among multiple levels of the government had become an important feature of Russian fiscal federalism as formal inter-governmental tax sharing laws were ignored and federal, regional and local tax collections were determined spontaneously based on political competition, conflicts and compromises between established federal, regional and local powers. Governments at different levels became involved in struggles with each other for tax rights over the same tax base. Consequently, too many agencies try to extract rents from the new private firms, making it unprofitable to create or run a private business, at least legally. This is in particular true for market entry barriers.[93]

High tax rates in Russia encouraged evasion and discouraged investment, reducing the tax base and aggregate tax collections. Johnson, Kaufmann and Shleifer (1997) show the Russian case in which the high tax burden is the main cause driving businesses into the unofficial economy. Consequently, federal and local tax collections had declined steadily, forcing governments at various levels to run budget deficits and slash expenditures on public goods such as education, police protection, public health, transport infrastructure and legal operations. As a result, with the exception of perhaps the cities of Moscow and St. Petersburg, the quality of public services has deteriorated during the transition.[94]

3.2.2 Demonetisation, Arrears, and Tax Sharing: Including Regional Governments into the Virtual Economy

The demonetisation of the Russian economy has been one of most significant developments throughout the transition period as enterprises run up mutual arrears to suppliers, workers or the state; or used money surrogates and bartered goods. The additional transaction costs resulting from increased intransparency in business and government accounting and high bargaining costs associated with barter and offset operations have arguably impeded efficiency and restructuring of the Russian economy. Evidently, the state has been supportive to this development by tolerating continuous increases in tax arrears or collecting taxes in kind with the total debt to consolidated budget growing from 1.8 percent of GDP in 1993 to 9.6 percent in 1998.[95]

In the literature different reasons to explain tax arrears and barter have been discussed. Some studies have concentrated on liquidity constraints resulting from restrictive monetary policy. Enterprises may accumulate tax arrears or pay in kind because they simply do not have liquidity to pay taxes. In the early 1990s the real economy reacted to the liquidity squeeze of the contractive monetary policy of the Federal Bank with a rapid growth in arrears and barter, which largely substituted for cash transactions. The rouble’s nearly four-fold nominal devaluation, which occurred from mid-1998 to mid-1999, resulted in a further contraction of the country’s money supply.[96] Demonetisation resulting from tight money supply, in turn, negatively affected tax collection. As enterprises had shifted en masse to barter, mutual non-payment, and money surrogates, such as promissory notes (veksel), tax authorities have been forced to collect in-kind tax payments.[97] These liquidity problems appear to have an even greater effect at the regional level, as some regions became much more demonetised in the 1990s than others. Whereas, for example the city of Moscow or St. Petersburg managed to collect over 70 percent of their total revenues in cash, in the Republic of Sakha the share of revenues collected in cash was as low as 40 percent. Gavrilenkov (2000) points out that more than 70 percent of firms’ money is allocated in the Moscow region. Whereas, for example in 1998 the share of money surrogates and arrears accounted for more than 60 percent in the republic of Sakha, the city of Moscow managed to collect over 70 percent of its revenue in cash.

92 See Shleifer and Treisman (2000).

93 A Mckinsey study of ten sectors on specific obstacles faced by new firm provides useful evidence. See Mckinsey (1999).

94 See Johnson, Kaufmann, Shleifer (1997)

95 Although non-payments and barter declined since 1999, there remain large amounts of debts between firms, wages left unpaid, fiscal obligations unfulfilled, and barter-based transactions.

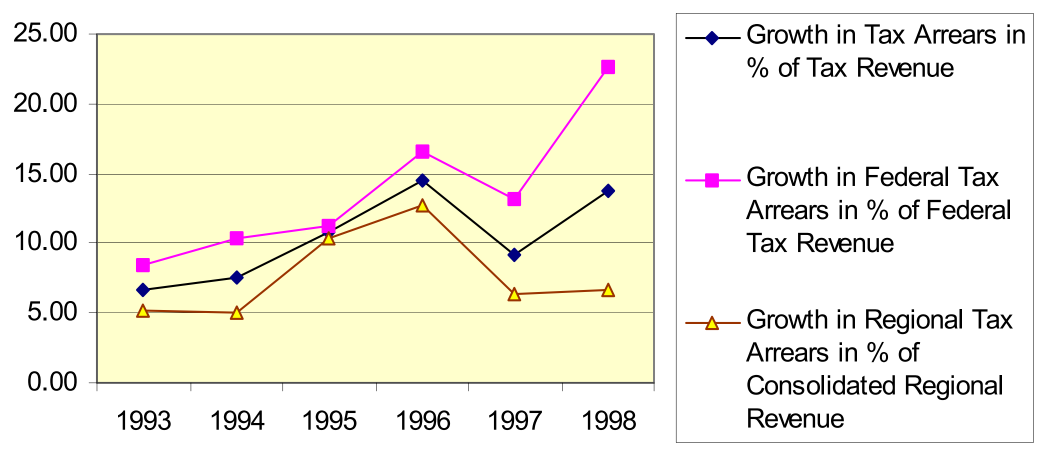
96 By mid-1999 M2 valued in dollars decreased to some 22.7 billion dollars, which was approximately the same as it was in 1994. In fact over 80 percent of Russia’s rouble M2 is money of private households, and the corporate sector permanently lacks cash flow. See Gavrilenkov (2000).

97 There could be several reasons for that: An enterprise could be profitable according to its books, but short of liquidity, because it is involved in a chain of inter-enterprise arrears; for instance, it experiences delays of payments for delivered products.

However, the most celebrated account of the underlying logic and the economic distortions associated with non-payments and barter was given by Gaddy and Ickes (1995).[98] In their view a combination of a weak and divided state, fears of the consequences of economic restructuring, and the power of interest groups in the mid-1990s led to (government supported) institutionalisation of non-payments and pervasive in kind exchange among enterprises and between enterprises and the state sector. Non-payments, according to this view, are the result of substantial forbearance by tax authorities toward enterprises' accumulation of arrears, which have played a significant role as indirect subsidies to firms in Russia. The epidemic of non-payment and the absence of corporate restructuring have thereby been mainly blamed on the federal government's inability or unwillingness to enforce strict tax and bankruptcy policies.

The original model of the virtual economy divides the Russian economy into three sectors – the value-adding export sector (largely oil and gas), the manufacturing sector that generates negative value-added, and the public sector. A look at figures disaggregating the government sector into regional and federal governments reveals a significant variation with respect to both the performance of tax collection and use of in kind payments. Figure 7 shows that stock of tax arrears to the consolidated budget went up steadily until the August 1998 crisis. Arrears to the federal budget accumulated almost with the same pace as the total stock of arrears before the crisis and stabilized after the crisis. In common parlance, the federal tax arrears have grown faster and declined slower than the regional arrears. Fig 8 illustrates the share of money surrogates in federal and consolidated regional budgets. Regional public finance is essentially based on non-cash transactions. In particular mutual offsets are more common at the regional level.

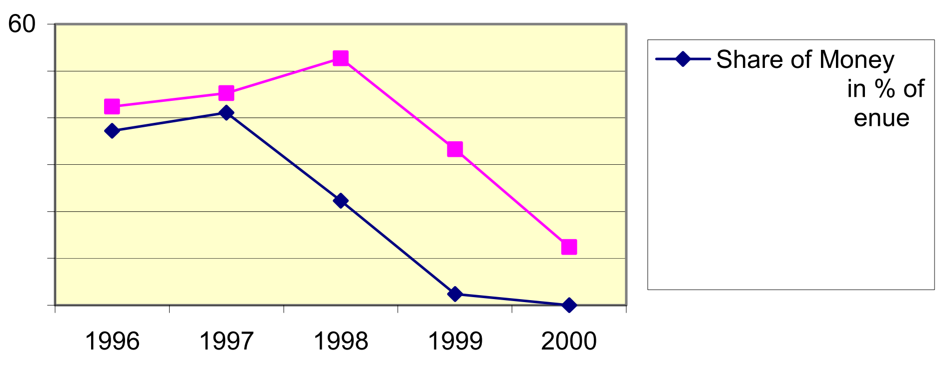
Fig. 7: Growth in Tax Arrears in % of Tax Revenue*



Whereas in the aggregated figures the widespread tax evasion and the use of mutual offsets shrunk not only the aggregated level of payments but also the monetary component, figures for the regional budgets reveal that comparatively higher rates of non-cash payments lead to comparatively lower growth in arrears. The evidence presented in these figures implies at least some divergence in the behaviour of the federal and regional governments. It should be noted that the state is not a monolith entity but a complex network of federal, regional and local power centres, with varying incentives. A more complete understanding of the demonetization of the Russian economy would thus require addressing the issue of distorted incentives for another important group of stakeholders in the Russian economy - regional governments - and the system of tax collection and tax sharing.

The ... current Russian ... system of tax ... sharing is not ... unique and has ... some

Fig. 8 The Share of Money Surrogates in Federal and Consolidated Regional Revenue*



98 They arg ... tion and that what ha ... of a pact between the ... continue supplying t ... favourable treatment) i ... Gaddy and Ickes (1998 ... ritique since. It wo ... tematic critique and
* OECD 20

advantages. It can be argued that tax sharing gives the regional authorities a stake in depriving the tax base and collecting federally defined taxes. Also the tragedy of the commons and the overgrazing problem can be avoided by setting aggregate tax rates at the revenue maximising point.[99]

However, the system has led to negative consequences in Russia, mainly because the division of property rights over these taxes has been very vague and the lack of clearly defined, stable and uniform revenue assignments between the centre and sub-national governments created adverse incentives for sub-national governments. The too frequent changes in the distribution of taxes among the different levels of government have deprived the regional leaders of the ability to develop their own tax bases or to simply reduce their efforts to mobilise shared revenues.[100] Under those conditions non-cash transactions have been means of facilitating tax evasion and evidence leaves little doubt that regional governments used such transactions to either hide locally mobilised taxes and to collude with enterprises to evade federal shares in tax revenues.[101]

Treisman (2000a), motivated by Shleifer and Treisman (2000), developed a model showing that accumulation of federal tax arrears in the second half of the '90s can be explained by the regional governors' protection of firms from the federal tax collectors. Strong governors protect firms in their regions from the federal tax collectors through the capture of local branches of federal courts and tax collection agencies. The model also suggests that regional authorities use protection from federal taxes as informal means in the tax competition to attract well-performing enterprises to their region by providing them with a better tax environment.[102] Thus, federal tax arrears in Russia have to some extent emerged as the result of a deal between the managers and local authorities on political protection of firms from federal tax collectors.

In reality there were several ways for regional governments to divert resource flows and increase their effective share of federal taxes, which all have in common that regional governments and regionally captured federal tax collectors accepted payments from enterprises in means the federal government was unwilling or unable to accept thus circumventing the sharing of these tax revenues. The use of regional bills of exchange or veksels was growing dramatically until new regulation restricted regional governments in 1997.[103]

Later tax offsets became a common mean of payment, by which regional governments tied tax revenue to their own budgets. Offset notes issued by the state were frequently used in public procurement to pay for goods and services delivered. The offset notes could in turn be used by the enterprise to settle tax payments. OECD (2000) shows how regional governments use mutual offsets to provide implicit subsidies to enterprises under their protection and at the same time increase their effective share in tax collections. Explicit subsidies have to be approved by the regional or local parliament and, according to the Law on Competition, cannot target individual enterprises. However, by allowing some enterprises to pay taxes at inflated offset prices, regional governments release implicit tax exemptions to enterprises in the region. Paying taxes in that way can encompass corruption. The fact that goods paid to offset taxes are overvalued is difficult to prove and officials have a great incentive to extract side-payments.[104] However, more importantly offsets affect the distribution of tax revenue between the different levels of government and increase the share within the region. Since the official sharing rules only apply for tax revenue paid in cash the presence of greater offsets leads to higher shares for the region than that prescribed by the Budget Law.[105] Offset operations are budget-specific, i.e. an enterprise will typically settle tax debts only to one budget as a result of a single offset operation. Offset notes are unlikely to be accepted by other government levels, thus they virtually tie revenues to a particular budget. However, since these offset notes are tradable, regional governments inject quasi money into the enterprise sector and those notes circulate as a parallel regional currency.[106]

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*OECD 2000

99 It is only the distribution among the different levels of government remains subject to competition without causing overburdening of the enterprise sector.

100 One of the few formal ways in which sub-national governments can independently raise more revenues is through more active involvement in the collection of local taxes, first of all the Property and the Land Taxes. That might to some decree explain why collections of taxes assigned to one level are generally collected more efficiently.

101 Shleifer and Treisman, 2000; Treisman, 2000a, and 2000b; and Lambert-Mogiliansky, et. al., 2000.

102 See Treiman (2000a) and Treisman (2000b).

103 See Shleifer and Treisman (2000).

104 The constantly low income level of Russian civil servants also of those that have financial responsibility is arguably another factor contributing to likeliness of the capture of political processes by vested interests. Explicit monthly wages in 1999 for the heads of financial departments in regional administrations fell into the range Rb. 1.500- 1.900, plus additional 50-70 percent in allowances. See. OECD 2000.

105 For the Federal government it is more costly to absorb Offsets and in Kind payments. See OECD (2000).

106 Debts can be traded according to Article 410 of the civil code. See Commander and Mumssen (1998).

As Woodruff (1999) argued demonetisation is partly a political phenomenon. The federal government lost the battle against regional governments and large firms have successfully challenged the federal monopoly to issue money.[107]

3.2.3 Soft Budget Constraints and the Viscous Circle of Federal Transfers

Beside the demonetisation of the economy, another institutionally embedded problem throughout the transition period has been the presence of soft budget constraints. As argued above establishing hard budget constraints in intergovernmental fiscal relations appears to be one important institutional prerequisite for a decentralised fiscal system to work without loss of essential fiscal restraint. Soft budget constraints imply that regional elites, which fail to spend revenues efficiently and to facilitate regional economic growth, are bailed out by discretionary transfers.[108] In the presence of soft budget constraints regional governments, despite their heavy dependence on federal assistance, face no serious pressure for fiscal adjustment. This is an extremely important factor with respect to both political accountability and economic efficiency. The challenge is thus to design fiscal transfer systems so that they contain opportunistic behaviour of sub-national governments and do not weaken the hard budget constraint.[109]

The vertical fiscal imbalance and in particular the practice of unfunded mandates have created a constellation in which sub-national governments have permanently pressed for more transfers, more loans, or both in order to fulfil their tasks.[110] The politically weakened central government facing a trade off between short-run interventions buying regional support and long-run reputation was feeble to commit itself to withhold bailouts. Pure distributional aims of fiscal transfers were also intervened by the political economy of fiscal transfers. Some of the transfers are intended primarily to achieve broader political goals such as maintaining stability by rewarding friends and buying off enemies.[111] Consequently, Russian intergovernmental budgetary relations have suffered a soft adjustment to budgetary needs of sub-national governments with manifold forms of distorting bailout practices.

Since, for example the distribution of FFSR grants was based on revenue projections derived from previous levels adjusted to the current year, regions could influence the process of calculation by claiming the actual revenue collections had been lower and expenditures higher than those used in the formula before the distribution was formally approved by the Duma. As a result transfers came to be heavily dependent on negotiations. They were distributed rather on an ad hoc basis than a formula basis thereby weakening incentives for budgetary discipline responsibility of lower levels of government. Since most budget deficits were financed by such federal fiscal transfers in the 1990s regional governments did not face any incentives to prune public spending. On contrary, regional governments anticipate that any improvements of their budgetary situation and reductions in their deficits lead to lower allocations from the FSFR. In fact, the number of regions receiving deficit grants increased each year.

Mutual settlements and budgetary loans are even less transparent than the FFSR grants. Such settlements are usually the consequence of bilateral bargaining and political lobbying of regions, which used them to upkeep social infrastructures and pay wages in the public sector. The observation of political events suggests the possibility of a perverse interaction between public employment and federal transfers in the late 1990s. The accumulation of wage arrears at the regional and local level of government has typically led to federal bailout and there are numerous examples of cases in which the federal government provided emergency financial aid to pay such wages.[112] For example, during the 1996 presidential campaign, Yeltsin's trips to regional capitals were almost always accompanied by new federal investments and a rush to retire the federal government's debts to workers, pensioners and enterprises in the province.[113] There is even some anecdotal evidence that strikes were organized by the highly popular regional governors to put pressure on the federal government to extract

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107 See Woodruff (2000).

108 See Rodden (2000).

109 The expectation that federal transfers will change to accommodate changes in regional budgetary has been identified in many studies as a disincentive for responsible budgetary management See Lavrov (1997) and Martinez-Vasquez and Boex (1998).

110 See Wallich (1994).

111 Ad hoc bilateral distribution of fiscal benefits was widely practiced, though these discretionary payments are much more difficult to track. Political economy aspects of tranfer policies are analysed by Treisman (1996), Solnik (1995), and Kirkow (1996).

112 Earle and Sabirianova (1999) argue that the institutionalization of wage arrears facilitated their spread across the economy.

113 See Treisman (2000b)

subsidies and transfers.[114] Moreover, governors may have consciously chosen to boost or at least slow decline arrears in local education, health, and administrative payrolls in the hope of attracting greater federal financial aid. Treisman (1999) finds empirical evidence that regions which received larger transfers and loans in 1996 or 1997 did not have lower arrears in education and healthcare in 1997. In fact, the correlation was positive.

The gap filling approach used in the methodology for distributing FFSR grants until 1999 and the political distribution of mutual settlements provided regions with incentives to lower tax collection and maintain obsolete infrastructures or extensive public employment in order to maximize intergovernmental transfers. This is a prime example of the infamous ratchet principle.[115]

However, beside budgetary slack and irresponsible public spending soft budget constraints were found to be the main obstacles for economic restructuring and have quite a negative impact on the reform process at the regional level. Various moral hazard problems arise from ill designed fiscal transfers. Some studies suggest that federal transfers have a significant negative impact on regional economic policies. Evidently, regional governments are responsible for most enterprise subsidies in the Russian fiscal system, which can be considered as major impediments for economic restructuring.[116] Freinkman and Haney (1997) suggest that regional dependence on federal support is an important determinant of the regional expenditure structure. They show that subsidies to inefficient enterprises increased in Russia's regions as transfers from the central budget increased.[117] These subsidies can be considered a serious barrier for restructuring of recipient enterprises, which are usually the largest local companies with a sufficient lobbying power to extract budget funds.[118] Therefore, regional subsidies are found have a strong negative impact on economic restructuring and growth.[119] In this respect, the existing mechanisms of transfer allocation seem to be quite harmful for the reform process: They not only help regional governments to delay restructuring in their expenditure policy but also indirectly protect firms from implementing structural reforms.

Moreover, the logic of this argument suggests, that - while the anticipation of "rewarding and punishing" voters at the polls is an important accountability mechanism for incumbent politicians - in the presence of continuous bailouts the “rascals” may not be thrown out but rather re-elected for their success in obtaining a larger share of other people's money.[120] Thus, incumbent governors remain largely politically unaccountable for the socio-economic performance of their regions.

The federal government eventually encourages “bad performers” that have a slower rate of reform and less compliance with federal economic policies with relatively more transfers, and therefore creates perverse incentives for regional governments.[121] The main recipients of federal funds are the most politically conservative regions that have often been most reluctant in implementing structural reforms promoted by the centre.[122] This argumentation is consistent with the results received by Treisman (1997) who finds evidence that the allocation of federal transfers in Russia is heavily biased towards the regions which are in deep political confrontation with the federal government creating incentives for regional governments to pursue noisy policies and to potentially encourage social unrest in their regions.

These considerations are very likely to be crucial elements of the complete story of the so called “red belt”. Regions within the red belt have been relatively slow to adopt federally initiated reforms, to reduce subsidies, liberalise prices and eliminate differences in administrative capabilities and, correspondingly, variations in the effectiveness of utilization of public resources and in the enforcement of legislation. Consequently, these regions

114 For instance, in February 2000, just before the scheduled presidential election, the governor of Omsk, Leonid Polezhaev, traveled to Moscow to negotiate for aid to pay striking teachers. He reportedly met with the finance minister and acting president Vladimir Putin. On arriving back in Omsk, Polezhaev's deputy “assured the strikers that the money necessary for paying out the teachers' salaries should arrive in the oblast in the next 10 days.” Institute for East-West Studies, Russian Regional Report, 5, 7, 24 February 2000.

115 Ratchet principle in public finance refers to a set of conditions under which administrations increase (at least do not decrease) present expenditures in anticipation of future revenue cuts related to potential savings. Improving budgetary perfomance today will only ratchet up the pressure for better performance in the future. See Weitzmann (1980)

116 A substantial portion of federal funds (30-40% of all disbursed transfers) is spent by the recipients on financing various subsidy programs. Freinkman and Haney (1997).

117 Freinkman and Haney (1997)

118 Empirical research finds that regional budgets subsidize primarily the largest local industrial enterprises as well as traditional former state farms in agriculture.

119 (Freinkman and Haney, 1997)

120 This is consitent with the empirical findings of Solnick who could not discern a relevant correlation between regional economic performances and probabilities of the incumbent governors 'victories.See Solnick (1996).

121 This result is unexpected when evaluated based on common sense: it seems controversial for the federal government to run a major budget program whose major beneficiaries are the main offenders of the federal policy.

122 See Treisman (1997).

have suffered relatively slower growth rates. Indeed, there has been extraordinary regional variation in real income growth within Russia since the break-up of the Soviet Union. For example, between 1993 and 1997, real income grew at a staggering annual average rate of 15.7 percent in Moscow, while it shrank at an annual average rate of -9.0 percent in Bryansk.[123] Empirical research has also found that the lack of growth is concentrated in regions associated with rather conservative political elites and gradual economic reforms.[124]

However, it is important to add that an explanation deriving this interregional growth gap mainly from regional economic policies would be hard to justify. Most of the economically weak regions are "born poor" as a consequence of limited resource endowments and other unfavourable initial conditions rather than "made poor" by rent-seeking and mismanagement. Initial conditions obviously predefine the scope for policy choices and make certain reform paths more likely to appear. They foremost affect costs and benefits of certain reforms and as argued in the theoretical part, the ratio between short term costs and long term benefits is one of the major determinants for political reforms to materialise or not. This is supported by cross regional empirical studies that suggest a very close relationship between policy choices of regional elites and initial economic conditions.[125] They show that regions within Russia with relatively high initial standards of living have tended to undertake relatively extensive economic reforms and vice versa. This is certainly not surprising. If growth prospects are very good then letting new firms enter and fostering growth is attractive. The example of Moscow, and of its mayor, Luzhkov, comes to mind here. On contrary, if a region is burdened by large loss-making but labour intensive enterprises and faces rather poor overall growth perspectives, a majority of the population will have rather conservative political preferences and regional leaders will be more hesitant to undertake radical reform policies and major economic restructuring.

Fiscal transfers naturally will go to regions of the second type with unfavourable initial conditions and less than average economic performance and if they are used for financing current expenditure such as budget deficits, wages or subsidies that protect enterprises from restructuring they bare an unavoidable tendency to contribute to the persistence of economic disparities. In the long run they may create socially costly and heavily subsidised bottomless pits.[126] To avoid this, public spending should instead be used to facilitate structural change and the development of economic structures that are competitive and financially self sufficient. However, this makes it important that transfer systems create institutional structures that provide regional politicians with incentives to pursue such sustainable economic policies. This can be done by the use of earmarked transfers rather than direct and lump sum budget support and through the introduction of political conditionality in federal transfer mechanisms, in particular on the non-accumulation of arrears on wages, payroll taxes, and utility payments. More dependent regions could not afford to lose federal transfers, and thus it may be expected that such regions could become more sensitive to federal guidance and could be eager to adjust their policies if non-compliance were to carry the risk of a fiscal loss. Also matching grants and co-financing in regional transfer policies can be considered as instruments to increase accountability for efficient spending, though they may produce asymmetrical results and increasing horizontal inequality rather than smoothing it.

The lack of such incentives has certainly been one of the weaknesses of the Russian system. Until recently, the grants provided by the central government through the Federal Fund for Financial Support of the Subjects of the Federation (FFSR) have neither had specific aims nor great conditionality.[127] Since the federal government could not control how regions use this money, it could hardly exert any influence on regional spending policies. Regional leaders tend to treat the federal grants as "other people's money," spending them irresponsibly. A large amount of the financial support provided to sub-national level was thus used only at current expenditure and did not provide for long term investment.[128]

The efficiency of the transfer system for budgetary and economic equalization can be assessed differently depending on the whether short term income or long term growth effects are in focus. Whereas, for example, Stewart (1997) concludes that fiscal transfers have smoothed fiscal disparities at least to some degree, the overall picture regarding the impact of the federal transfers seems rather unfavourable for the federal government.[129] While transfers to regions are quite expensive and remain one of the major expenditure items in the federal budget, the federal government managed to "buy" surprisingly little with this money.

123 See (Berkowitz and DeJong, 2001a)

124 See Berkowitz and DeJong (1999).

125 See Jefferson and Rawski (1994) and de Melo and Ofer (1999).

126 For theoretical underpinnings that ill-designed transfers can end up underwriting inertia, waste, and corruption see for example Litvack et al. 1998 and Meagher and Korsun 1997.

127 The obligatory exception are those going to the northern regions, including Arkhangelskaya oblast and the far east, and some other subsidies in the federal budgets for 2000 and 2001

128 See Hanson (2000).

129 Stewart (1997). See also McAuley (1997).

3.2.4 Regional State Capture

So far we have seen that a part of the delayed restructuring of the Russian economy is due to policies of regional governments generating transfers to loss-making firms. There was also presented evidence that regional governments have colluded with enterprises to evade tax payments to the central government. Beside the outlined incentive problems deriving directly from the institutional design of the fiscal system another important factor certainly contributing to its malfunctioning is that sub-national governments have been captured by special interest groups, say initial rent holders and primarily by old firms which dominated the Russian economy before the transition. The strength of these stakeholders is a very important puzzle in the big picture of governance quality in post-soviet Russia, which certainly separates the Russian case from many unindustrialised development countries, among others China, in which outside the government no strong pressure groups exist.[130]
Indeed many of the Russian regions suffer from initial conditions of mono-industrial economic structures inherited from the politically steered Soviet system of inter-regional division of labour. The artificial geographical distribution of enterprises and capital assets often had less to do with market signals than with administrative preferences of the state. Consequently, industries are very often localised and unevenly distributed across the country and certain regions may exhibit higher concentrations of certain crops or industries.[131] In many regions this in particular creates a burden of large loss-making enterprises that form a key part of the region's social and economic infrastructure constraining the scope for political manoeuvring for regional governments.

Consistent with the arguments put forward in the theoretical part regional governments are more vulnerable because social and political ramifications and effects of liquidation or restructuring of such enterprises on regional governments are potentially high creating a bargaining leverage for enterprises. It is no accident, that regional governments not only have generally been more likely to allocate direct subsidies and tax breaks according to signals and pressures exercised by local interest groups, but have increasingly become the pillars to firms and social protection.

Regional political and economic interests maintain close ties at regional level. What has occurred is not just the organisation of strong enterprise lobbies that engage in extracting rents and seek political protection from regional governments, but the actual instalment of enterprise staff within regional administrations. Recently a number of prominent businessmen even have been elected governor, including Zolotarev Chukotka Governor Roman Abramovich and Taimyr Governor Aleksandr Khloponin, and local businessmen, such as Perm Governor Yurii Trutnev.[132] In the absence of effective conflict of interest regulation this tells a lot about the penetration of regional governments by powerful business interests.

Indeed regional governments have responded to vested interests by collecting revenues in kind from profitable enterprises while tolerating tax arrears from loss-making firms in order to maintain the latter's employment levels. These regional governments shield insiders from takeover attempts, obstruct the enforcement of outsiders' property rights, and perpetuate the system of using enterprises as sources of private benefits for managers and local officials, and sources of social and political benefits for the region. In exchange for regional protection, enterprises maintain inefficiently high employment, pay bribes to the governors, or increase regional portion of their tax payments. As argued above, the latter may happen because the federal and regional tax bases overlap. Using a large sample of enterprises Zhusravskaia et al for example found that tax arrears in 1996 and 1997 were higher in firms that had higher employment for a given level of output. [133]

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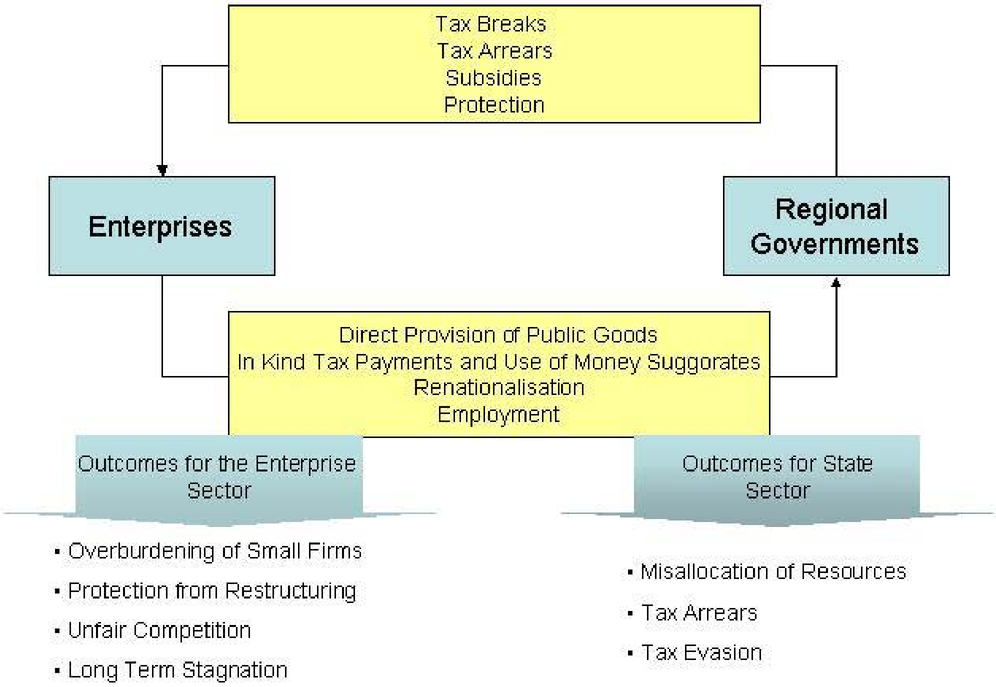
130 In public discourse the so called oligarchs gained much attention. A academic account on the strength of private pressure groups and state capture see Hellmann (1998).

131 One company cities are perhaps the most visible manifestation of this.

132 This trend is relatively new. Before the 2000-2001 round of governors' elections, the only former businessmen who became governors were Kalmykiya's Kirsan Ilyumzhinov and the Nenets Autonomous Okrug's Vladimir Butov. Additionally, Siberian Aluminum backed the election of Aleksei Lebed in Khakasiya.See Nezavisimaya gazeta 5. Juni 2001 and Stoner Weiss (2000).

133 See Zhusravskaia and Ponomareva (2000).

Fig 9 Political Logic and Economic Outcomes of Regional State Capture



In addition the institutionalisation of long-term bilateral relations between sub-national state organs and enterprises for direct provision of public goods and services supports a policy favouring large incumbent firms that have the capacity to supply such goods and services.[134] Most large enterprises inherited social infrastructures such as housing, hospitals, and nursery schools from soviet times. In return for this provision firms can receive various special privileges from the regional government, including explicit or implicit tax exemptions, debt restructuring and protection from bankruptcy or competition in particular against the federal government. Anecdotal evidence is provided by the publicly known manufacturer Autovaz which is by far the largest employer in the Samara Oblast. At the end of 1997 the federal government published a list with the worst offenders of tax payments among which was Autovaz, and threatened to close it down if it did not pay its huge tax debts. However, after joint lobbying with the regional government Autovaz was not closed and only part of the tax arrears were settled.[135]

As argued above the ability of the state to treat enterprises differently can create costly market distortions. Local capture and collusive deals thus imply efficiency losses. The political economy of rent seeking certainly benefits at large the cost of small and medium enterprises. For large Russian firms tax payments are more a matter of discretion and bargaining power than taxation rules given that regional and federal governments generally care about their survival. Consequently, industrial dinosaurs are casually protected by regional governments and face no incentives to restructure whereas small enterprises were forced into the underground economy by extensive taxation.[136]

Beside the efficiency loss and cost deriving from stalled restructuring there are other significant side effects of the outlined practices. Broadman and Recanatini (2001) find that interregional labour turnover does not adjust to great differences in labour demand and supply and significant income differentials among Russia's regions.[137] Despite substantial improvements since the start of transition, workers mobility across Russia's regions is still quite limited creating inefficient bottlenecks on the labour market. Arguably, implicit institutional barriers - such as enterprise-tied housing additional to explicit barriers such as local residency requirements (propiska) - create distorting incentives and constraints on interregional labour market mobility.

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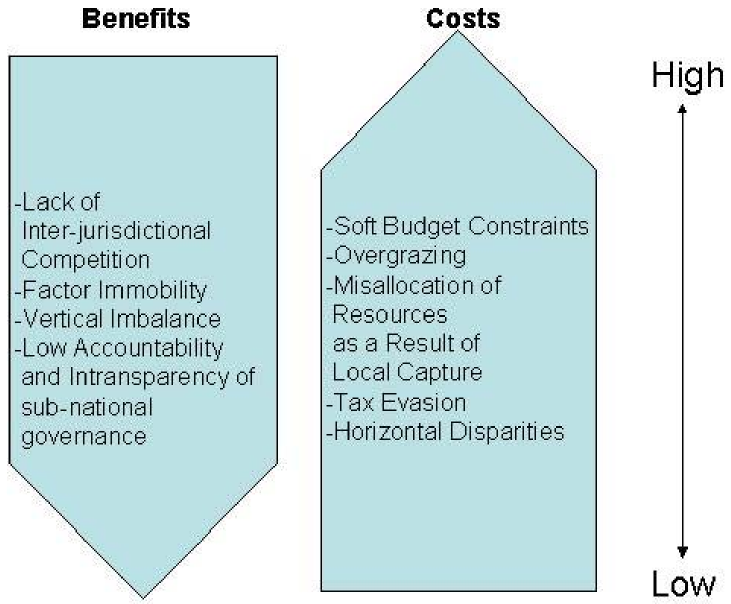
134 Complicated bilateral agreements between enterprises and regional administrations are a common practice in Russia.
135 See Shleifer and Treisman (2000).
136 See Shleifer and Treiman (2000).
137 Broadman and Recanatini (2001)

IV. Synthetic Discussion: Making Decentralisation Work

In 2001 the Russian Finance Ministry will complete the implementation of its Conception for Reforming Inter-budgetary Relations in the Russian Federation in 1999-2001. This reform plan was prepared by a three-party Commission comprising representatives from the Russian government, the Council of the Federation, and the State Duma, which has subsequently made proposals for reforming inter-budgetary relations in Russia.[138] Its main ideas, including new methods for the distribution of transfers and sharing taxes among the three principal levels of government, were implemented by the federal government in the reform plan which was approved on July 30, 1998, and in the 1999 federal budget. The reform plan sought to improve fiscal relations between the federal and regional governments by improving the way money is distributed from the Fund for the Financial Support of the Regions. It also sought to address the problem of "unfunded mandates," by creating a Compensation Fund and created lines in the federal budget for establishing a Regional Development Fund and a Fund for Developing Regional Finances. [139]
However, many issues were not addressed and now a new medium-term action plan for the period 2001-2005 has been prepared and was made public at meeting on 23 May 2002, when Prime Minister Mikhail Kasyanov announced the parameters of Russia's 2002 budget.[140] The program generally suggests further clarifying of the distribution of taxing power among federal, regional, and local governments. One of the most important parts of the program is the gradual shift away from the current system, in which Russia's various taxes are divided among different levels of government, to a "one tax one budget" system where one tax would go entirely to one level of government. Another important recommendation is to implement a federal law that strengthens local government in terms of independent revenue and spending authority. To address this problem, the reform program suggests amendments to the Budget Code that would clarify what a local government is, what budgetary right it has, and how a local government can raise money. The reform program also recommends amendments to the Tax Code that clarify the taxing rights of local governments.[141] Another significant change is that in 2002, the federal government will restrict tax base export and require firms to pay taxes in the regions where they actually conduct their activities rather than where they are registered.[142] The government also plans to set up a social program co-financing fund, which will match every rouble a region spends on social programs with a federal rouble, regardless of the level of income in the region.

138 Rossiiskaia gazeta No. 151 (8.August 1998)
139 Though the government estimates that unfunded mandates still amounted to 600 billion roubles in 2001 or 8 percent of the country's GDP. See Nezavisimaya gazeta, 24 May 2002.
140 See Kommerant Daily, 24 May 2002 and Nezavisimaya gazeta, 24 May 2002.
141 The plan has been criticised to reflect the interests of the federal government by regional leaders In particular the economically robust regions complain that the federal government is taking too much money from them, while the relatively poor regions believe that they are not getting sufficient aid. Kommerant Daily, 24 May 2002.
142Since many companies are registered in Moscow, the capital currently gets a much larger share of tax revenue than it will under the new system. For example Moscow city and oblast collect taxes for 20-25 percent of Russia's natural gas production even though these regions do not have any natural gas deposits.

Fig. 10: High Costs and Low Benefits: Decentralised Governance in the Russian Federation



Against the background of those most recent attempts to reform intergovernmental relations the findings of the paper are of high practical relevance. Indeed, the paper found that various aspects of the system of intergovernmental relations have created adverse incentives. The incentive structure resulting from the institutional design of fiscal federalism helps to explain Russia's governance problems manifest in the falling of federal revenues, growing tax evasion, demonetisation and distortive state capture by vested interests. Under the current system officials who control over public finance are unaccountable to the public. They neither face institutional incentives to raise revenue by growth enhancing policies, nor do they have an interest in spending public money effectively. Regional governments thus generally contribute to stagnant growth and the persistence of widespread unofficial economic activity in Russia in the 90s.

Some parts of the current reform address precisely the incentive problems arising from existing institutional settings in line with the argumentation put forward here.[143] Based on the given analysis a call for higher real decentralisation, in particular of taxation powers, seems justified because the assignment of certain taxes to the regional level would tie tax revenues more closely to the economic performance of the region thus increasing incentives to foster growth. However, it is the experience of Russia in 1994-1996 that suggests that the devolution of the taxation power can create counterproductive vertical externalities. Thus, if the tax authority is assigned to sub-national levels there should be frame conditions set by national level in order to enforce a certain decree tax harmonisation and prevent overgrazing.

Another important factor that should be taken into consideration is regional equalisation.[144] The assignment of more taxation power to lower levels would further reduce revenues of poor regions and thus cement existing disparities in the region's economic base. Resulting gaps in income and fiscal endowments arguably necessitate a strong federal presence for the smoothing of inequality.[145] Generally, on grounds of the given analysis and the

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143 Other reform proposals seem to follow Lavrov (2001), who argues that the fundamental contradiction between the highly centralized formal system and informal sub-national autonomy is a major source of problems in fiscal federalism in Russia.The result is that the regional leaders resort to illegal methods of raising and spending money, such as the creation of off-budget funds and the introduction of additional revenue producing methods. See Lavrov (2000).

144 Federal redistribution policies aim at smoothing the differences between the regions and, thus, the federal government would provide support to the relatively poor regions. The growing disparaities cause political tensions and the federal government is vulnerable to political pressures from rich regions that oppose the redistribution of fiscal revenues.

145 See Morozov (1999).

particular situation in Russia it seems reasonable to devolve expenditure authority more seriously than tax authority, as apparently happened in Russia.

The paper thus supports a strong role of the national government on the revenue side. Generally, the assignment of some strategically important taxes that give regional governments a stake in the overall economic development of their region, such as a regional profit tax could be accompanied by measures that increase the total federal revenue share. Such a trade off might be politically suitable.

Given the sheer size of Russia and the related informational advantages the case should be made for a balanced decentralisation of expenditures that still allow many of the gains from decentralization without producing vertical externalities and horizontal disparities.[146] The resulting vertical imbalance has to be countervailed by transfer measures. However it was found that the ill designed transfer system is responsible for much of the malfunctioning of budgetary relations in Russia. Until 1999 FFSR grants were associated with fiscal disincentives because the formula was based on an inversed dependence of transfers on budgetary performance, which offered at least some scope for opportunistic shifts of expenditure obligations to other levels of government. Dependent regions thus had neither faced pressure nor incentives to improve their fiscal situation in the long run. However, the methodology and allocation of transfers has been improved since. In 1998 the government approved a new concept of intergovernmental fiscal relation reform. The reform was aiming at moving away from negotiation to transparent distribution and to adopt a program more equalising. Another significant change it introduced was a revision of the used formula, depending less on recent budgetary performance in given region.[147] However, the introduction of political conditionality in federal transfer mechanisms, in particular on the non-accumulation of arrears on wages, payroll taxes, and utility payments should be envisaged in order to constrain regional opportunism.

In terms of the underlying theoretical approach by thinking together decentralisation, governance, and economic outcomes "Market Preserving Federalism" certainly is a valuable theoretical concept for the analysis of federalism in Russia and other transition countries. Indeed, it has been demonstrated that the Russian case involves a cross violation of virtually all the necessary institutional foundations for market preserving federalism. On that ground it comes as no surprise that fiscal decentralisation in Russia has been a contributing factor to the persisting economic problems, e.g. inefficient tax collection, lack of economic restructuring, barter and arrears. Because of its rather normative approach and its focus on institutional aspects the concept of market preserving federalism potentially accounts to less for initial conditions and the political economy of institutional change.[148] It has thus some limits when applied without taking into account political constraints, e.g. the strength of different regions and groups.[149]

In contrast, the understanding of the institutions and norms provided here shows that a successful reform strategy is not only a matter of choosing market preserving institutions but that the process of institutional change has to be addressed as such. In fact, in the transition environment sound governance structures and institutions have the characteristics of public goods and the same collective dilemma applies to their emergence as applies to other public goods. The typical citizen will only get a small share of the aggregated benefit of more effective policies and institutions: in the aggregate, the other residents of the country will get almost all benefits, so that the individual citizen only has a marginal incentive to devote much time and effort in engaging for the socially optimal institutional choices. The typical citizen is rationally ignorant about what institutional choices and policies would serve the interests of a majority.[150]

146 Such as Lower cost production, informational advantages etc. as suggested in the theoretical part. Nevertheless, despite those arguments some of the benefits of fiscal federalism, like people choosing low tax-low spending jurisdictions over high tax-high spending jurisdictions, involve the devolution of the power to tax and these benefits would be lost if only expenditure responsibilities were devolved. If Russia is to benefit from those effects greater sub-national taxation autonomy is indeed a necessary institutional prerequisite. However, the high decree of factor immobility mainly will remain a impediment to interjurisdictionary competition. Thus, any reform of the tax system has to be complemented by efforts to decrease impediments to factor mobility.

147 The formula includes an adjusted Gross regional Product (GRP) measure as an indicator for fiscal capacity of region. This indicator is then weighed by an expenditure needs coefficient which is based n regional subsistence level and other indicators of regional expenditure needs. See Martinez-Vasquez (2001).

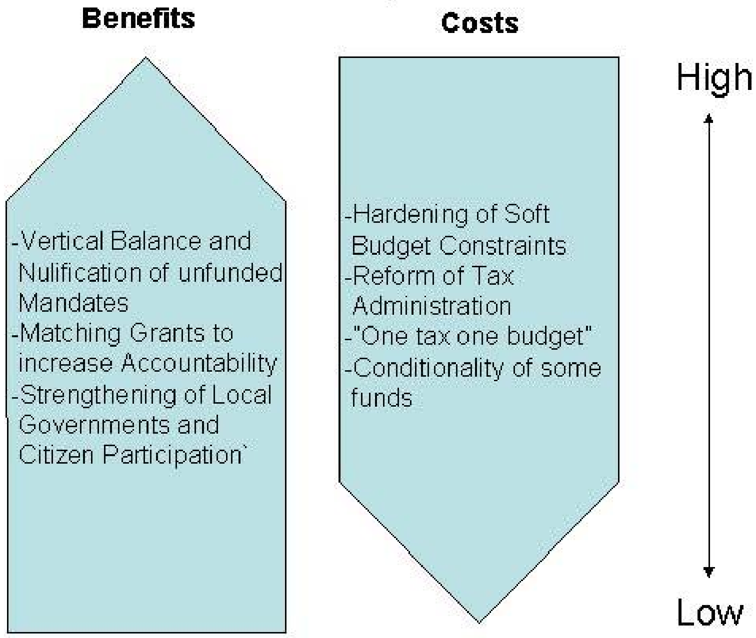
148 For example Russia's sheer size with poor transportation and financial market infrastructure limits factor mobility and thus potentially weakens the benefits from competition between regions under market preserving federalism.

149 This is also one of the weaknesses in respect to cross country comparisons. In particular, the extensively used comparison between China's successful and growth enhancing decentralisation in the Russian case turns out to fall to short, when focussed only on institutional foundations of fiscal federalism because Market preserving federalism in China came at the cost of a democracy restricting political system. In contrast to Russia where the central state has been fairly weak China serves as a prime example of an in the words of Riker- extremely centralised federalism.

150 See Olson (2000)

On the other hand strong incentives may develop for special interest groups to maintain an inequitable and inefficient status quo. Some empirical studies even see the key to development in the ability of the state to insulate economic management from the pressure of short run rent seeking by powerful interest groups.[151] Consistent with these observations the Russian evidence so far suggests that the state has been subject to capture by vested interest. Hellmann (1997) argued that early winners from transition, which benefit from existing institutional settings, have successfully captured parts of the state to protect their rent seeking opportunities. This paper injects further theoretical and empirical content into this line of argument. It suggests that a similar argument can be applied to institutional deficiencies of the Russian federalism. Just as some citizens and groups profit from second-best institutions, for example property rights, created during the transition, so do some regional administrations benefit from the existing system of federalism.[152] Property transfers, federal subsidies, bribes and rents directly to regions are both rival and exclusive goods, and presumably more valuable to regional leaders than the public goods of "market preserving federalism" and the longer-term goals of limited government and economic growth that can only be obtained collectively. Moreover, state capture has been more pervasive at the regional level. Regional governments have colluded with large enterprises to avoid tax payments and restructuring to benefit special interest groups at the cost of overall economic development. Any reform attempt will - to be successful - have to solve these deep distributional conflicts embedded in existing state institutions and dilute the likely resistance of the beneficiaries of the existing institutions.

Fig. 11: Making Decentralisation Work in the Russian Federation: Institutional Prerequisites



This leads to my final point – though the main focus of this paper - institutional changes in organisation of the state alone will not do it. With respect to improvement of governance perhaps the most important change in the incentive environment of regional and federal politicians is to empower the users of public goods themselves with voice. In political science literature there has been a focus on the connection between "social capital" and the performance of political institutions that establish and uphold the rule of law and thus facilitate economic growth. In his path-breaking research on Italy Robert Putnam defined social capital as a cultural phenomenon, denoting the extent of civic mindedness of members of a society, the existence of social norms promoting collective acting and the degree of trust in public institutions. Putnam's study also found that governments that were more open to constituent pressure managed and delivered services more efficiently. [153] The success of any

151 See Bardhan (1988):

152 Most elaborately this line of argument has been developed by Hellman (1998).

153 Putnam's study of regional government in Italy during the 1970s and 1980s found that although political and economic failures due to weaknesses in formal institutional arrangements were generally widespread, some regional governments, particularly those in the North, had performed comparatively well. Northern regional

organisational reform in Russia's federal system will fall short if the people are not empowered to formulate their demands, to broadly participate in policy making and to monitor the states performance. As always: Time will show.

Sebastian Eckardt **Jakarta, 2001**

governments were notable for developing innovative day care programs and job training centres, managing the public's business efficiently, and satisfying their constituents. Regional government in the South, by contrast, showed much weaker responsiveness and performance. The study attributed the better performance of northern governments to the external pressure created by dense networks of civic associations and citizen involvement in local public affairs.

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