
Federalism in Russia

EKATERINA ZHURAVSKAYA

Reforms during the 1990s in Russia entailed not only economic liberalization and democratization but also transition from a highly centralized unitary state to a highly decentralized federal state. Since the advent of Vladimir Putin's presidency, former president Boris Yeltsin's experiments with decentralization have been recognized as unsuccessful and as leading to the very collapse of Russia. A consensus has emerged—among scholars, politicians, and the society at large—that the attempt to build a successful federal system in the 1990s badly failed. The new Russian leadership has been consistently taking measures since 2000 to recentralize both public finance and politics. This chapter addresses the following questions: Why did Yeltsin's decentralization fail? What mistakes (if any) were made in the 1990s? How effective is Putin's reversal of Yeltsin's decentralization? Where is the notorious “vertical of power” taking Russia?

These questions have no easy answers, but the experience of other federal states and an examination of Russia's own political economy of intergovernmental relations suggest that the approach being implemented now is no less dangerous than the spontaneous decentralization of the 1990s. Indeed, because of the size of the country and the heterogeneity of its regions, federalism in Russia is inevitable. For the effective functioning of the principles of federalism, Russia needs the “vertical of power,” which political economists refer to as political centralization. The “verticals,” however, can be different. Other countries' experience with federalism, particularly Mexico and China, shows that the measures that Putin and company are undertaking are unlikely to succeed.

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Three main lessons emerge from my analysis in this chapter. First, without a strong, functioning, and real opposition and free media, the federal center will not be able to pursue efficient policies, unless one hopes for a miracle. The fact that such a miracle is happening in China is not a guarantee that it can happen on Russian soil. The transition of the last 20 years has clearly demonstrated that transplants do not take root without special conditions, and Russia has clearly violated these conditions.

Second, federalism combined with the absence of elections at the local level can potentially work only when the policy is designed solely to deliver economic growth and is not aimed at providing public goods, such as quality education, health care, and social protection. Such a one-sided goal is politically feasible only in poor countries, but Russia is in the higher middle-income group.

Third, an alternative to Putin's centralization exists, but it entails a complete change of the political system. Obviously it is not easy to implement and obviously the current leadership does not have an interest in trying to do so, but if implemented, it can achieve the balance between political centralization and local accountability necessary for effective federalism. This alternative scenario is in building strong national political parties, together with maintaining political competition by preserving political opposition and free media, as well as holding open and free elections at all levels.

Principles of Federalism

To develop successfully a country needs a system of providing incentives to public officials. Incentives are needed to ensure that bureaucrats and politicians work for the benefit of the people instead of doing nothing or using public office for private gain. The task of creating such a system of incentives for countries with vast territory and diverse population is much more complicated than for small and homogeneous states. First, in these countries, it is much more difficult, compared with small states, to define what is "good for the people." For example, in large and heterogeneous countries, such as Russia, central authorities have much less information about the preferences of people in different parts of the country. And often, the available information is not enough for central provision of public goods to be effective. Second, central management of a large country involves a large state apparatus. Effective control of a large bureaucracy is very complicated, expensive, and not always feasible. For these reasons, authority over public goods provision should be delegated to lower-level governments, in the hope that they will serve the interests of the local population. Because of its vast size and economic and ethnic diversity, Russia cannot be managed efficiently from the center as a corporation in contrast to, for example, Belarus, Mongolia, or Lithuania. Therefore, the answer to the question about whether to delegate authority to the local level is obvious. Instead, the question should be: How should decentralization of authority be designed for federalism to work in Russia?

Based on the experience of developed, wealthy federations, such as the United States and Switzerland, many scholars, including such pillars of economic thought as Friedrich von Hayek and Charles Mills Tiebout, independently came to the conclusion that the delegation of authority to local governments works just fine if three “simple” conditions are met. Two of these conditions are necessary to create political incentives and one to create economic incentives for local authorities. The conditions to create political incentives are: (1) mobility, allowing people to “vote with their feet,” and (2) development of democracy, allowing people to “vote with their heart.” Poorly performing local politicians lose constituent populations or at least votes in elections. The third condition is necessary to create economic incentives, also known as fiscal incentives. In addition to delegating responsibility to provide public goods, a functioning federalist system must also delegate the authority to every level of government to collect taxes to cover the costs of providing public goods at that level. This way local authorities have incentives to provide these public goods efficiently, i.e., at the lowest cost.

Do these conditions apply to Russian federalism? Are these conditions necessary and/or sufficient for Russia? To understand answers to these questions, it is important to understand the history of Russia’s federalism, which I describe briefly in the next section. The history consists of two distinct periods with opposite trends: first, Yeltsin’s decentralization of 1991–99; and second, Putin’s centralization from 2000 onward. Figures 3.1 and 3.2 portray the dynamics of subnational expenditure and revenue shares, vividly demonstrating the differences between the two periods. Under Yeltsin’s rule, regional shares of revenue and expenditure were growing, but when Putin assumed power, regional revenue shares started declining, while shares of expenditure remained approximately constant.

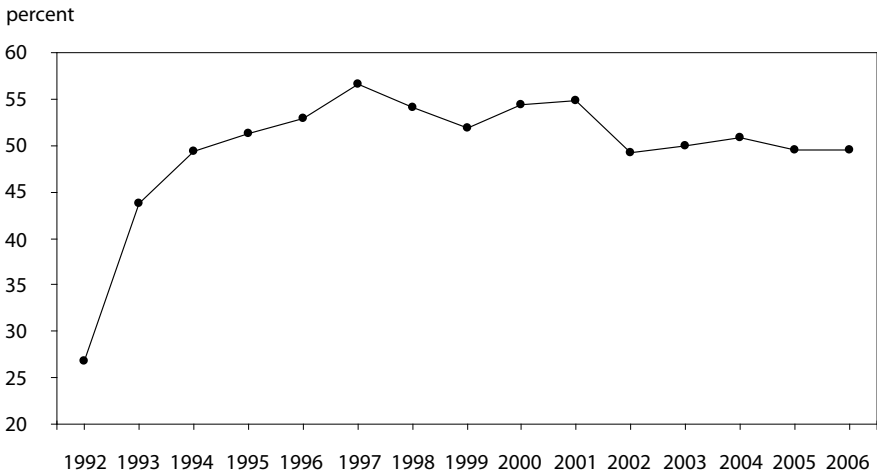
Yeltsin’s Decentralization in the 1990s

Russia of the early 1990s inherited a highly centralized Soviet system of intergovernmental fiscal relations, in which the center used financial transfers to the regions as a means to maintain the integrity of the empire. These transfers were purely politically motivated and did not take into account economic considerations.

Fiscal and political decentralization was also driven solely by political motivations. To conduct reforms, President Yeltsin needed the support of regional leaders.¹ The delegation of substantial financial and political autonomy to the regions (in Yeltsin’s own words “as much as regions can assume”) in exchange for their loyalty was a forced political compromise that allowed liberalization and privatization. Without decentralization,

1. As wonderfully described by Andrei Shleifer and Daniel Treisman, *Without a Map: Political Tactics and Economic Reform in Russia* (Cambridge, MA: MIT Press, 2000).

Figure 3.1 Share of subnational expenditures in total outlays of national and subnational governments without extrabudgetary funds, 1992–2006



Source: Migara O. De Silva, Galina Kurlyandskaya, Elena Andreeva, and Natalia Golovanova, *Intergovernmental Reforms in the Russian Federation: One Step Forward, Two Steps Back?* (Washington: World Bank, 2009) based on Russian Ministry of Finance data (excluding extrabudgetary funds).

through which the center bought temporary support of governors, basic liberalization reforms would have been politically infeasible.

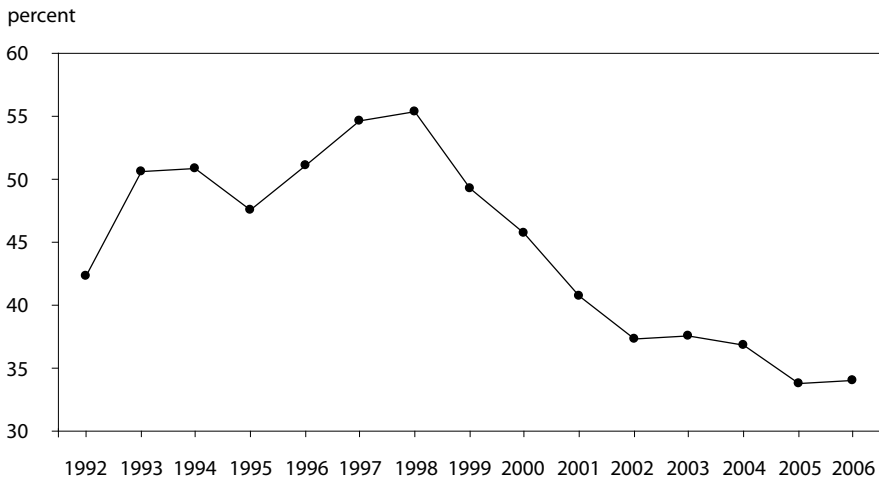
The transfer of fiscal authority from the center to the regions took the form of chaotic informal bargaining, and cash transfers became a tool in the political game. At different points in time, they were allocated to loyal regions as a reward or to opposition regions as a bribe.²

The sequencing of power transfers to the regions was disorderly but far from random. Yeltsin gave political autonomy first to the most politically powerful regions: two metropolitan areas (St. Petersburg and Moscow) and six republics (not counting Chechnya),³ where elections were held in 1991. In addition, Yeltsin allowed elections first in the poorest regions with the worst fiscal results. At the end of 1991, a five-year moratorium on elections for regional leaders appointed by Yeltsin was proclaimed, but during this period 31 regional elections in the most

2. For empirical evidence, see Daniel Treisman, "The Politics of Intergovernmental Transfers in Post-Soviet Russia," *British Journal of Political Science* 26 (1996): 299–335; Vladimir Popov, "Fiscal Federalism in Russia: Rules versus Electoral Politics," *Comparative Economic Studies* 44, no. 4 (2004): 515–41; and Elena Jarocinska, "Are Intergovernmental Grants Tactical? Evidence from Russia," *Economics of Transition* (forthcoming 2010).

3. Elections in Chechnya were considered illegitimate.

Figure 3.2 Share of subnational revenues in total revenues of national and subnational governments without extrabudgetary funds, 1992–2006



Source: Migara O. De Silva, Galina Kurlyandskaya, Elena Andreeva, and Natalia Golovanova, *Intergovernmental Reforms in the Russian Federation: One Step Forward, Two Steps Back?* (Washington: World Bank, 2009) based on Russian Ministry of Finance data (excluding extrabudgetary funds).

economically troublesome regions took place with his consent (and two without). This evidence illustrates another important political rationale for decentralization: When the economy is not doing well, central authorities are interested in political decentralization to push responsibility for poor performance of the economy onto subnational governments.

Thus, decentralization was conducted purely for political reasons: first, to provide support for liberal reforms at the center, which—as everybody expected at first—were supposed to produce rapid growth, and subsequently, to push responsibility for the failure to deliver the expected economic growth onto the regional governments. Because decentralization at the time was politically motivated, its economic effects were never considered. Historical and economic analyses of the outcome of Yeltsin’s chaotic decentralization of the early 1990s suggest it certainly contributed to the reasons why the expected growth did not come about for a long time after transition had started.

Principles of Federalism Violated

Russia of the 1990s provides an important lesson about what happens when delegation of power to local authorities takes place in an environment that is not ideal, i.e., without the benchmark principles of federalism

from Western democracies mentioned earlier. Indeed, Russia violated all three principles. Decentralization was characterized by poor local accountability and nontransparent division of expenditure responsibilities and revenue assignments. No one but regional business elites constrained the power of regional governors. Local elections rarely worked as a disciplining device, as the election's outcome depended on the notorious "administrative resource" rather than the performance of the governors. Legislative and judicial powers as well as the local press often were under the direct control of the governors and did not provide checks and balances. In addition, low mobility of the population due to prohibitively high economic costs of migration in most regions made it impossible for people to "vote with their feet," i.e., to escape from the provincial regions to Moscow.⁴

Fragile democratic institutions at the local level made regional governments in Russia easily susceptible to "capture" by new wealth. Politically powerful firms influenced the rules of the game in the economy: They prevented competition by hindering development of businesses and changed the direction and speed of economic reforms.⁵ The 1999 Business Environment and Enterprise Performance Survey⁶ confirmed that state capture was deeply rooted in economic and political processes of the country: In the composite index of state capture among 20 transition countries, Russia ranked fourth.⁷

Irina Slinko, Evgeny Yakovlev, and I created a measure of state capture in the Russian regions based on Russian legislation in 1992–2000 and evaluated the effects of capture by politically influential firms.⁸ Although the study found no robust evidence that capture had a significant impact on aggregate economic growth, it showed that the economy was suffering from state capture by powerful elites. Firms without political influence stagnated; their productivity, sales, and investments declined with an increase in state capture of the regions. Growth of regional small businesses was also hampered; their share of employment and retail turnover went

4. Yuri Andrienko and Sergei Guriev, "Determinants of Interregional Mobility in Russia," *Economics of Transition* 12, no. 1 (2004): 1–27.

5. For a theoretical model of state capture with an application to Russia's context, see Konstantin Sonin, "Why the Rich May Favor Poor Protection of Property Rights," *Journal of Comparative Economics* 31, no. 4 (2003): 715–31.

6. European Bank for Reconstruction and Development (EBRD) and World Bank, Business Environment and Enterprise Performance Survey (BEEPS), www.worldbank.org.

7. Joel S. Hellman and Mark Schankerman, "Intervention, Corruption and Capture," *Economics of Transition* 8, no. 3 (2000): 545–76; Joel S. Hellman, Geraint Jones, Daniel Kaufmann, and Mark Schankerman, "Measuring Governance, Corruption, and State Capture: How Firms and Bureaucrats Shape the Business Environment in Transition Economies," World Bank Policy Research Working Paper no. 2312 (Washington: World Bank, 2000).

8. Irina Slinko, Evgeny Yakovlev, and Ekaterina Zhuravskaya, "Laws for Sale: Evidence from Russia," *American Law and Economics Review* 7, no. 1 (2005): 284–318.

down with the growth in regional capture. Regional budgets were also negatively affected: Tax collection decreased and arrears to budgets increased, leading to a deterioration in regional public goods provision.

A survey of mayors of large Russian cities in 1996 showed that in the first half of the 1990s fiscal incentives in the major cities were very weak.⁹ Revenue sharing between regional and local governments gave no incentive to local governments to increase the tax base or provide public goods. Both the positive and negative changes in large cities' revenue were almost entirely compensated for by changes in shared revenue (through adjustments in tax-sharing rates and size of regional transfers). Alexey Makrushin, Slinko, and I conducted a more general study using the same methodology and data for more than a thousand municipal budgets for the second half of the 1990s.¹⁰ Our results confirmed that the additional revenues of municipalities were expropriated by regional authorities through changes in the percentage of deductions from regulatory taxes and size of the transfer and that this was particularly severe for big urban municipalities. Furthermore, weak fiscal incentives led to local governments' overregulation of private businesses and deterioration in the level and efficiency of public goods provision.¹¹

The gross mismatch of expenditure responsibilities and taxing authority at all levels as well as unclear division of authority/responsibility undermined fiscal incentives further. Daniel Berkowitz and Wei Li studied the consequences of overlapping tax bases of different levels of government in Russia in the 1990s.¹² They showed that when governments at different levels simultaneously tax the same base, the tax base becomes a common property resource, which leads to overtaxation. Such poor division of taxing authority in Russia prompted gross tax evasion, discouraged investment, and reduced aggregate tax collections. Berkowitz and Li argued that federal and local tax collections declined steadily in the 1990s, forcing governments at various levels to slash expenditures on public goods such as education, police protection, public health, transport infrastructure, and law enforcement.

Several indepth investigations of intergovernmental relations in Russia of the 1990s showed that corruption, state capture, and subversion of

9. See Ekaterina Zhuravskaya, "Incentives to Provide Local Public Goods: Fiscal Federalism—Russian Style," *Journal of Public Economics* 76, no. 3 (2000): 337–68.

10. Alexey Makrushin, Irina Slinko, and Ekaterina Zhuravskaya, "The Reasons for Bad Fiscal Incentives in Russia" (policy paper, Center for Economic and Financial Research at the New Economic School, Moscow, 2002).

11. Zhuravskaya, "Incentives to Provide Local Public Goods: Fiscal Federalism—Russian Style."

12. Daniel Berkowitz and Wei Li, "Tax Rights in Transition Economies: A Tragedy of the Commons?" *Journal of Public Economics* 76, no. 3 (June 2000): 369–97.

budget funds arose from direct violation of the three principles for the establishment of political and economic incentives. These principles are embedded in the constitutions of an overwhelming majority of developed federations, such as the United States and Switzerland, but developing federations routinely violate these principles, and Russia of the 1990s is only one example. However, this is not the only bad news for developing federations.

State-Corroding Federalism

Policies that benefit population in one region may directly harm populations of neighboring regions and, as a result, hurt the country as a whole. Even if such policies do not violate the principles of accountability of local authorities or of correspondence of revenues and expenditures and fully reflect the needs of the local people, delegation of authority to the local level could lead to truly disastrous outcomes for the country as a whole. Thus, additional conditions need to be formulated to avoid disruptive regionalist policies as an outcome of federalism. I return to this issue later as it is highly relevant to the development of Russia's federalism.

Indeed, Russia in the 1990s provides a vivid example of one of the most important costs of federalism in developing federations, namely, severe interregional externalities, which Hongbin Cai and Daniel Treisman called "state-corroding federalism."¹³

In the 1990s, regional authorities helped enterprises in their territories avoid paying federal taxes. This weakened the fiscal capacity of the federal center and undermined the provision of federal public goods. Federal tax collection efforts were impaired because the agents who carried out tax collection and enforcement in the regions—formally federal employees—as well as the regional judiciary—formally independent—were often under the control of regional governments. Aleksei Lavrov, John Litwack, and Douglas Sutherland wrote: "Federal organs operating in the regions typically have close relations with the regional administration, depending on the latter for a number of reasons, sometimes even for the provision of office space."¹⁴ Ariane Lambert-Mogiliansky, Konstantin Sonin, and I documented that regional governments used the regional judiciary to redistribute tax revenue from the federal center to the regions via bankruptcy proceedings.¹⁵ Marina Ponomareva and I showed that politically strong

13. Hongbin Cai and Daniel Treisman, "State-Corroding Federalism," *Journal of Public Economics* 88 (2004): 819–43.

14. Aleksei Lavrov, John M. Litwack, and Douglas Sutherland, *Fiscal Federalist Relations in Russia: A Case for Subnational Autonomy* (Paris: OECD Center for Cooperation with Non-Members, 2001).

15. Ariane Lambert-Mogiliansky, Konstantin Sonin, and Ekaterina Zhuravskaya, "Are

governors successfully resisted federal tax collection in their regions.¹⁶ Federal arrears were higher and accumulated faster in regions that were in a better bargaining position than the center or where governors had a larger popular base or were in open political opposition to the center.¹⁷ Moreover, these regions not only managed to disrupt the federal government's tax collection efforts but also were successful in bargaining with the center for official tax deferrals on behalf of regional companies.

Interregional trade barriers were also a pervasive phenomenon in Russia in the 1990s. Berkowitz and David DeJong demonstrated this using evidence on large price dispersions across regions.¹⁸ Yakovlev summarized numerous examples of regional legislation that set tariff and nontariff barriers to trade in Russia's regional alcohol markets,¹⁹ while Sergei Guriev, Yakovlev, and I presented two case studies from beer and copper extraction industries to illustrate that interregional trade barriers were particularly strong in regions where politically powerful regional lobbyists concentrated their business interests.²⁰ Overall, interregional protectionism created local monopolies and destroyed the single economic space within a country.

Uncontrolled access to credit by regional authorities under the security of the federal budget and production of money surrogates, such as regional "veksels," were very common in the first half of 1990s and led to disastrous macroeconomic consequences.²¹

Overall, the outcome of Yeltsin's decentralization in the 1990s was severe: deterioration of public goods in general and at the local level in particular; increased corruption; high level of state capture at the local

Russian Commercial Courts Biased? Evidence from a Bankruptcy Law Transplant," *Journal of Comparative Economics* 35, no. 2 (2007): 254–77.

16. Marina Ponomareva and Ekaterina Zhuravskaya, "Federal Tax Arrears in Russia: Liquidity Problems, Federal Subsidies, or Regional Protection," *Economics of Transition* 12, no. 3 (2004): 373–98.

17. See also Konstantin Sonin, "Provincial Protectionism," *Journal of Comparative Economics* (forthcoming 2010).

18. Daniel Berkowitz and David N. DeJong, "Russia's Internal Border," *Regional Science and Urban Economics* 29, no. 5 (September 1999): 633–49.

19. Evgeny Yakovlev, "Political Economy of Regulation: Case Study of Russian Regional Alcohol Markets," EERC Working Paper (Economics Education and Research Consortium, 2005).

20. Sergei Guriev, Evgeny Yakovlev, and Ekaterina Zhuravskaya, "Interest Group Politics in a Federation," Discussion Paper no. 6671 (Washington: Center for Economic Policy and Research, 2009).

21. See, for example, Ruben Enikolopov, Alexey Makrushin, and Ekaterina Zhuravskaya, "Fiscal Federalism in Russia: Problems and Perspectives" (policy paper, Center for Economic and Financial Research at the New Economic School, Moscow, 2003).

level by local elites; fragmentation of the country's economic (market) space into separate autarchic subnational units; macroeconomic instability caused by the center's loss of monopoly power on issuing money; and corrosion of the central state due to the loss of instruments for efficient collection of federal taxes. By the end of the 1990s, it became apparent that Russia needed a reform of federalism.

Reforming State-Corroding Federalism: Lessons from Other Developing Countries

How can a state-corroding federalist system be reformed? This question was on the agenda when Putin assumed power and is certainly still relevant to Russia's present and future. Since the problems of Russia's federalism are far from unique—Mexico faced similar challenges in the 1920s and 1930s and Argentina and Brazil have been facing them since the second half of the last century—the experiences of developing federations, including more successful ones such as China, are useful in finding an answer to this question.

The solution to the problem of interjurisdictional externalities is in properly designed political incentives for local officials. How can one ensure that local officials carrying out a regional policy take into account the interests of the population of other jurisdictions of the country, while not forgetting about the population of their own jurisdiction? There are two ways to achieve this. William Riker offered one practical way.²² He argued that the essential condition for the existence of an effective federation—in addition to the three conditions described earlier—is the existence of strong national political parties that create political incentives for local politicians to internalize externalities on neighbors and the center from the regional policy. Strong national parties create political incentives for local politicians by providing prospects for promotion within the party hierarchy based on their actions and by supporting them in local elections (when local policies are benign). Strong national political parties have enabled the most successful developed federations, such as the United States, Australia, and Switzerland, to avoid “too regionalist” policies in their states or cantons. Riker argued that having strong national parties are an additional (fourth) necessary condition for the success of federalism.

Another possible way to prevent regional leaders from pursuing policies that are harmful to the country as a whole is for the center to appoint them. If regional leaders are appointed and not elected, the center can create career concerns for them by basing promotions and demotions on their actions.

22. William Riker, *Federalism: Origins, Operation, Significance* (Boston: Little, Brown, and Co., 1964).

Ruben Enikolopov and I used panel data on 75 developing and transition countries over the past 25 years and showed that the presence of strong national political parties indeed has a positive effect on fiscal decentralization (confirming Riker's idea), whereas administrative appointments of local authorities by the center (instead of local elections), on average, do not improve public goods or the quality of governance in developing federations.²³ Interestingly, abolition of local elections, on average, does not necessarily improve federalism even in very young democracies, where, apparently, elections on the ground do not work at all as an institution of accountability. The important reason for this lies in the incentives for rent seeking in the center.

Federalism in China and Mexico

Olivier Blanchard and Andrei Shleifer compared Russia's and China's fiscal decentralizations and argued that China provides a good example of how the center should create conditions under which regional governments have no incentives to pursue policies with negative externalities using such "administrative federalism."²⁴ It is important to note that even though China is a highly politically centralized unitary state, from an economic standpoint it is a federation; provincial leaders have substantial and exclusive authority over many aspects of regional fiscal and regulatory policy. In particular, provincial leaders in China, i.e., provincial party secretaries and governors, have sufficient discretion over policy that they can substantially affect economic growth in their territory, but there is plenty of evidence that their policies are less "regionalist" than those of many other developing federations (including Russia). Blanchard and Shleifer argued that the provincial leaders' need to please the center for reappointment explains their less regionalist actions. Thus, the Chinese Communist Party is a watchdog ensuring that provincial leaders act in the national interest. Many scholars agree that the unprecedented high economic growth in China over the past 30 years is indeed linked to Chinese federalism, i.e., the synthesis of substantial fiscal autonomy of provinces and strict administrative subordination of provincial governments to the center.

However, Chinese-style federalism has its problems. First, the administrative power of the center leads to a situation where local authorities are not accountable to their population and, therefore, lose interest in the needs of local people and act solely in the interests of the central govern-

23. Ruben Enikolopov and Ekaterina Zhuravskaya, "Decentralization and Political Institutions," *Journal of Public Economics* 91, no. 11-12 (2007): 2261-90.

24. Olivier Blanchard and Andrei Shleifer, "Federalism With and Without Political Centralization: China versus Russia," in *Transition Economies: How Much Progress?* IMF Staff Paper (Washington: International Monetary Fund, 2001).

ment. This, in theory, should undermine one of the main advantages of federalism (why a country would want to decentralize in the first place), namely, the closeness of local governments to the local population, which creates important informational advantages over the central government.²⁵ Chinese federalism was a result of fast economic growth, which in turn was a consequence of local public policies supporting businesses and market infrastructure. However, little progress is observed in public goods provision to the population, such as education, health care, and social protection, which is still rudimentary.

Why do observers who admire Chinese federalism largely ignore this issue? A country has different priorities at different stages of development. China is a rapidly growing but poor country. At this stage, the central government can afford not to make public goods provision a priority over growth. However, as China develops, priorities will change, and this change will seriously challenge the Chinese system of federalism. The reason is a standard moral hazard problem with multitasking: Multiple goals undermine the power of the incentive scheme created by administrative federalism. As Russia is a lot richer than China, it may not be politically feasible for Russia's central government to deem public goods provision a less important objective and ignore it.

The second fundamental problem with the Chinese system of federalism, and perhaps the most important for Russia, is that this system, as any miracle, cannot be replicated. It is a miracle that in China the central government, whose power is in no way limited due to the autocratic nature of the Communist Party, acts in the interests of national economic growth and not in its own interests of rent seeking.

Analysis of the Chinese experience and that of other countries suggests that a prerequisite for well-functioning administrative federalism is benevolence of the representatives of central authority, i.e., despite the many opportunities for rent seeking, they think and act to accelerate economic growth and improve public welfare. Unfortunately, this condition is grossly violated in most countries, whether young or mature democracies or dictatorships. The fewer the constraints on executives, the more likely the rent seeking at the central level. Thus, for Russia, administrative federalism is a dead end. At present, Chinese federalism, without a doubt, is one of the most interesting and important puzzles for economics and political and other social sciences. No more or less convincing explanation exists yet for why politicians and bureaucrats in Beijing are doing everything they can to support economic growth. And since there is no such explanation, there is no reason to see the Chinese experience as a guide to action but as just a miracle.

Another important example for Russia is the case of Mexico in the

25. Friedrich A. Hayek, *Individualism and Economic Order* (Chicago: University of Chicago Press, 1948).

1920s and 1930s, which was developing much like Russia in the 1990s. In the 1950s, the ruling Institutional Revolutionary Party (PRI) gave leaders of Mexican states attractive career prospects in the federal government. The strengthening of the party's political influence in the states streamlined the tax system and substantially restrained the states' protectionist policies. This resulted in significant economic growth coupled with low inflation in the 1950s and 1970s, often referred to as the "Mexican miracle."

Political centralization did not, however, stop at this first stage, which greatly benefited economic growth. Economic and fiscal centralization followed. By the 1980s, the PRI faced no political opposition, and, because of lack of accountability at the center, party elites mainly focused on extraction of rents and strengthening their own power, rather than on effective federalist policies. The central government became interested in gaining control over fiscal resources. Under a one-party system (PRI), there were no commitment devices to stop recentralization. As a result, local authorities lost fiscal autonomy, which significantly reduced their incentives to pursue growth-promoting policies. In the end, in the late 1990s, massive centralization led to a series of crises, and the PRI lost power.

Mexico in the 1980s is a clear example of how the lack of political opposition poses a major systemic threat to administrative federalism: Federal officials who have a great deal of political power cannot commit to refraining from stripping fiscal autonomy of the regions, which in turn undermines the basic idea of federalism. In other words, in the absence of political opposition and political competition, federalism may not be sustainable as the center would want to recentralize all powers, including fiscal powers.

Putin's Centralization: Follow Mexico or China?

To address the severe problems brought about by Yeltsin's federalism, President Putin started reforming the state apparatus soon after assuming power. This reform largely seemed to follow Blanchard and Shleifer's advice. Though never officially declared, Putin took the Chinese example as a model for reform of Russia's federalism. From 2000 to 2004, he undertook a number of important steps to increase the political influence of the central government and reduce that of regions on policy design and its implementation at all levels.

Changes in the formation of the upper house of Russia's parliament (the Federation Council) and the establishment of federal districts and presidential envoys to these districts marked the beginning of this process. Both of these measures took place in 2000. The first significantly reduced the influence of governors on the federal legislation. Governors and the heads of regional legislatures—formerly *ex officio* members of the Federation Council—were replaced by designated professional representatives. The second measure was intended to increase federal control over the im-

plementation of federal legislation on the ground; previously, such control was almost completely absent. Soon after presidential envoys were introduced, it became clear that they were significantly less legitimate and less politically powerful compared with elected governors.

The next reform step was declared on September 13, 2004, when Putin announced significant changes in the formation of the state apparatus. Elections of regional governors were cancelled starting in January 2005 and from then on the president personally appointed governors. Direct majoritarian elections in single-member districts, which previously existed for one-half of the seats in the lower house of Russia's parliament, the Duma, were replaced with proportional representation from party lists with a simultaneous increase in the threshold required for parties to qualify for election. The administration's explanations for these drastic measures came later and were in line with the Chinese model and very much in the spirit of Blanchard and Shleifer: Putin called these reforms "the logical development of Russia's federalism." The need to restore the "vertical of power" was why regional elections were abolished. The need to strengthen the party system was why parliamentary elections were reformed. The latter corresponds quite well with Riker's idea.

Important reforms of intergovernmental fiscal relations also took place starting in 1999. These reforms aimed at and largely achieved streamlining of intergovernmental transfers with the help of a transparent grant-allocation formula and eliminated federal expenditure mandates to regions that were not financed with appropriate federal transfers. These certainly were important changes for the better.²⁶

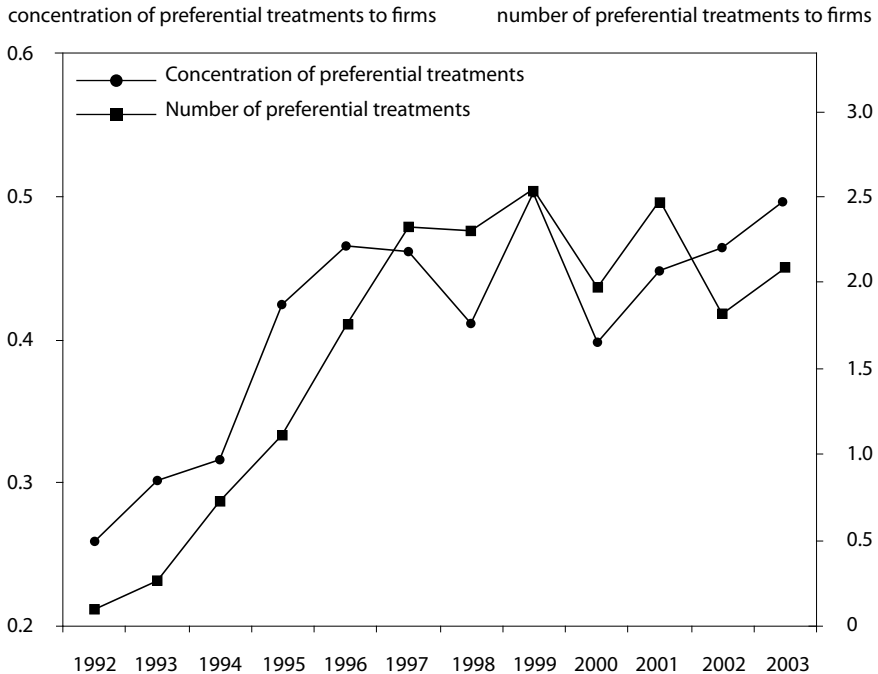
Enough time has passed since these changes were implemented to observe the outcomes of Putin's centralization. In particular, enough data are available to judge whether the reform had the desired effects on the extent of state capture at the regional level and on career concerns for regional leaders.

Yakovlev and I showed that despite political centralization there have been no significant changes in the overall level of state capture at the regional level in Russia between Yeltsin's era and Putin's first term in power.²⁷ Figure 3.3 portrays the dynamics of two measures of regional capture: the number and concentration of preferential treatment of particular large regional firms by regional governments. The right axis (number of preferential treatments) is the actual average number of firms that received preferential treatment from the regional authorities in each

26. I focus on the political side of Putin's reform in this chapter; for a detailed account of the fiscal side, see Migara O. De Silva, Galina Kurlyandskaya, Elena Andreeva, and Natalia Golovanova, *Intergovernmental Reforms in the Russian Federation: One Step Forward, Two Steps Back?* (Washington: World Bank, 2009).

27. Evgeny Yakovlev and Ekaterina Zhuravskaya, "State Capture: From Yeltsin to Putin," in *Corruption, Development and Institutional Design*, ed. János Kornai, L. László Mátyás, and Gérard Roland (New York: Palgrave Macmillan, 2009).

Figure 3.3 Extent of state capture measured by the number and concentration of preferential treatments, 1992–2003



Source: Evgeny Yakovlev and Ekaterina Zhuravskaya, "State Capture: From Yeltsin to Putin," in *Corruption, Development and Institutional Design*, ed. János Kornai, L. László Mátyás, and Gérard Roland (New York: Palgrave Macmillan, 2009).

of the years shown. For example, in 1993, one firm in four regions got preferential treatment; in contrast, in 2003, two firms on average in each region got preferential treatment. The left axis (concentration of preferential treatments) is the Herfindahl-Hirschman index of concentration. It shows the probability that the same firm in a region got two randomly drawn preferential treatments in each year. For example, concentration was very low in 1992: If and when several preferential treatments were given, they most certainly went to different rather than the same firms.

Though there were no significant changes in overall level of state capture, there has been an important change in the nature of the most influential groups between Yeltsin's era and Putin's first term in power: Bargaining power within regions has shifted from private firms, particularly those belonging to the largest industrial groups, as well as from firms owned by regional governments to firms owned by the federal government. The latter have become the most politically powerful lobbyists at the regional level. Thus, instead of limiting the extent of state capture, Putin's reform

so far has only changed the identity of the captors. This, however, may have actually restrained some of the negative externalities of regionalist policies as firms in federal ownership probably internalize some of these external effects (as Guriev, Yakovlev, and I showed using trade barriers as an example²⁸). Yet, the “vertical of power” should have led to a decline in the overall level of capture as the central government was supposed to reinstate equal treatment of firms by regional law and government regulations. Putin’s centralization clearly failed to meet this objective.

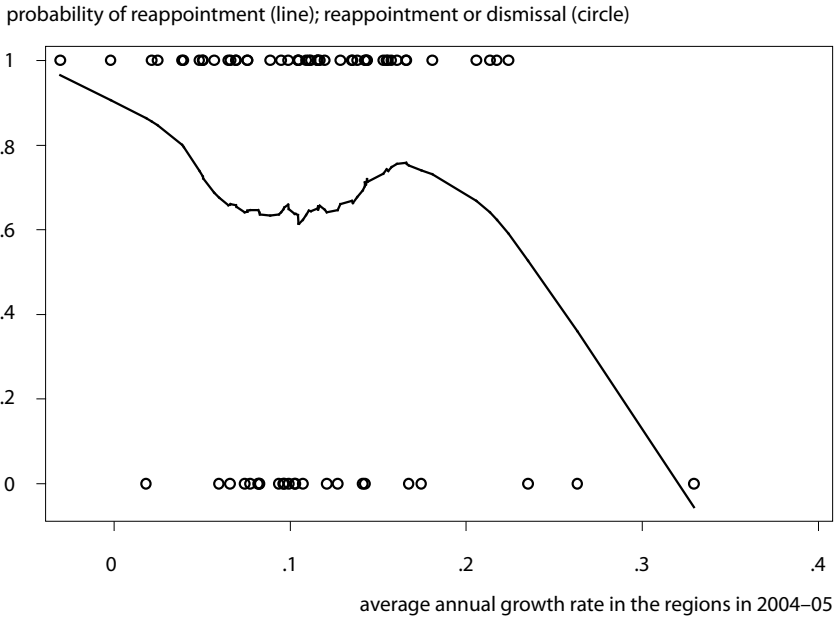
Over the course of 2005–07, Putin made 74 decisions about appointments of regional leaders. In 2005, 33 governors were reappointed and 9 were dismissed. In 2006, 5 were reappointed and 3 were dismissed. In 2007, 12 governors were reappointed and 12 were dismissed. It is interesting to see whether the decision to reappoint a particular governor depends on the economic performance of the region.²⁹ A simple calculation of the average annual real growth rate in the regions in 2004–05 and the probability of reappointments of governors by the president based on the growth rate (shown by the solid line in figure 3.4) indicates that, if anything, the correlation between reappointment and economic performance of the region is negative (see figure 3.4). 2004–05 was a period of fast growth—average growth was about 9 percent per annum, i.e., 0.09 on the horizontal axis of figure 3.4. The circles in the figure are the actual dismissals and reappointments in the regions after the 2005 federalism reform, where 1 is reappointment and 0 is dismissal. The figure clearly shows that the relationship between growth rate and reappointments is negative, if anything, which gives no incentives for governors to improve economic performance in their regions.

The pair-wise correlation is statistically insignificant and becomes significant once we control for the 2002 level of per capita gross regional product. It is clear from the figure (and is confirmed by regression analysis) that the statistical significance of the negative correlation depends on a few outliers: replacement of Alu Alhanov by young Ramzan Kadyrov in March 2007 in Chechnya and of Ivan Malahov by Alexander Horoshavin in Sakhalin oblast after the Nevelsk earthquake and reappointment of Roman Abramovitch in Chukotka in November 2005 and of Kirsan Ilyumzhinov in Kalmykia also in November 2005. In any case, there is clearly no evidence of a positive relationship between economic performance and regional reappointments.

28. Ibid.

29. Many studies have shown that provincial economic growth is the main determinant of promotions and demotions of Chinese provincial leaders. See, for instance, Hongbin Li and Li-An Zhou, “Political Turnover and Economic Performance: The Incentive Role of Personnel Control in China,” *Journal of Public Economics* 89, no. 9-10 (2005): 1743–62; Ye Chen, Hongbin Li, and Li-An Zhou, “Relative Performance Evaluation and the Turnover of Provincial Leaders in China,” *Economics Letters* 88, no. 3 (2005): 421–25.

Figure 3.4 Annual average growth rate in the regions and reappointment of governors: Nonparametric average regression (Lowess smoother)



The most striking example is the reappointment of the governor of the Republic of Kalmykia, Kirsan Ilyumzhinov. For 12 years under the leadership of Ilyumzhinov (before his reappointment by Putin), Kalmykia was one of the least developed and poorest regions. During this time, Kalmykia was the only region in Russia’s history to declare bankruptcy as outstanding debts of the republic exceeded its annual budget. Federal investigations suggested that federal transfers systematically disappeared without a trace from Kalmykia’s budget. According to Rosstat, in 1993, when Ilyumzhinov was first elected head of the republic, in terms of per capita income of the population, it was the seventh poorest region of all Russian regions (excluding autonomous Okrugs), and after ten years of Ilyumzhinov’s governance, Kalmykia dropped to third place. Unemployment in the republic also has grown significantly, and by the time of Ilyumzhinov’s reappointment, unemployment was lower than that in only a few regions in the Caucasus. There is little doubt that Ilyumzhinov is

grossly unpopular in the republic.³⁰ Yet, Ilyumzhinov gained the trust of President Putin to lead the region again in 2005.

An important question is why a strong central leader would want to reappoint badly performing governors? One reason is political motivation. Inefficient governors are unpopular and, therefore, cannot become independent political figures and cannot (even potentially) lead the opposition to the ruling central government. Second, and perhaps the easiest explanation, is rent seeking. The central government can use the threat of dismissal to persuade local authorities to give greater part of their rents to federal officials. It is obvious that rent-seeking regional governors can offer a larger sum for their reappointment. Moreover, incumbents have more information and rents and collect them better than outsiders; thus, they can pay more for their jobs.

Of course, it is theoretically possible that changing the system of appointment will radically change the behavior of governors, because their incentive structure would change, which means that it is irrelevant how they behaved before the reform. However, governors who have engaged in rent-seeking behavior for years must have accumulated implicit obligations to special interest groups in their regions, and the interests of these groups do not always coincide with those of the public at large. To break such ties between local governors and local elites, the central reformer interested in streamlining a state-corroding federalist system needs to bring in new people. Thus, even in a case where federal officials have absolute integrity (which I mentioned earlier in the context of transplanting Chinese federalism to Russia), it would make sense to fire most governors who held office under the old system. Yet, as of November 2009, 24 governors in office have been ruling their regions for more than 10 years.

Conclusion

Russia has much to learn from other developing federations. First, for successful development, it needs a federal structure of government, as the country is too large and too diverse to be a unitary state. Second, effective operation of Russia's federalism is possible only if there is a strong political "vertical," which would limit inefficient regionalist policies of individual subjects. However, creation of the administrative vertical by abolishing regional elections, as Putin did, has created two major problems for Russia: (1) inadequate provision of public goods in the absence of accountability of local governments to the local population, and (2) complete depen-

30. Tom Parfitt, "King of Kalmykia," *Guardian*, September 21, 2006, www.guardian.co.uk (accessed on April 28, 2010); Regnum News Agency, "Residents of Kalmykia ask EU countries, USA and Canada for political asylum," November 2, 2005, www.regnum.ru/english (accessed on April 28, 2010); and Pravda, "Leader of Kalmyk republic blackmails the Kremlin," November 6, 2004, <http://english.pravda.ru> (accessed on April 28, 2010).

dence on the utopian assumption of honesty and self-limitation of federal authorities, without which administrative federalism is unsustainable.

The alternative to administrative federalism is creation of a political vertical through strong national political parties. Strong national parties, while preserving local elections, maintain the balance of political incentives for local authorities between the interests of regional and national populations. However, successful operation and sustainability of this approach requires institutional constraints on the central organs of the ruling party as insurance against use of the vertical for personal gain by senior party and government officials. The only effective way to create such a system of checks and balances of federal officials and party bosses is the development of democracy, i.e., strong national opposition parties and independent media, both at national and subnational levels. Unfortunately, it is pretty clear that the Russian leadership interprets the concept of a strong political party system not as having strong opposition but as Mexico's PRI system in the late 1980s.

Even in the zero-probability event that a "Russian miracle" occurs in the absence of political competition, as in China, there will always be a great danger that officials focused on the welfare of the population will be replaced at some point by those focusing mainly on their own well-being. Therefore, long-term success of federalism in Russia depends hugely on promoting democracy at all levels. Russia has a long way to go in establishing democratic institutions (and so far the trend has been in the opposite direction), but it is the only way for Russia's federalism to work.

