

The Political Economy of Federalism in Russia

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The debates on the optimal size of a government bureau, the efficient organizational pyramid of the bureaucracy, the political economy of rent-seeking activities, and income redistribution are inextricably linked to the study of federalism in the context of the political economy and the economics of property rights. In this article, I will concentrate on the problems of implementing a federal structure in a command economy undergoing a dual transition—to the market and to democracy—in Russia. By analyzing Russian federalism, I will attempt to shed more light on one of the root causes of many of Russia's economic and political problems: a lack of bureaucratic reform, with an emphasis on the consolidation of the rule of law.

As a guideline to this analysis, it is useful to consider two approaches to analyzing federal structures. First, there is the “benevolent government” framework that assumes that the government wants to increase social welfare by reducing transaction costs and providing a desirable level of public goods. The second approach analyzes federalism as any private sector institution that emerges because of unexploited gains that rational agents wish to internalize. There is hardly any direct emphasis on social welfare in this approach, and any marginal improvements in aggregate welfare are results of the welfare-maximizing characteristics of politics conducted in a democratic, market-oriented economy. The government in this approach is viewed as a leviathan.

As an example of the first approach, consider the decentralization theorem. Oates suggested, quite simply, that if a unitary system of governance imposes welfare costs that are higher than those of a federal system, then we could expect a more compelling case for more governance units.¹ If the unitary government provides an amount of public service that is the average of its major administrative units, for instance, then the welfare cost it imposes on the system will vary positively with the heterogeneity of demand among the units. Therefore, the average amount of service supplied by the federal government would be

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more acceptable if the distance between the highest demanders and the lowest demanders were less. This insight is very simple in its logic and has the merit of being easily testable. A further benefit is the transportability of the argument in analyzing centralized redistribution across goods and services for which a subunit demand exists in the system. The trouble, however, with this line of reasoning is that it loses its value in assessing new proposals, where it must rely only on an *ex post* analysis.

The elasticity of demand for publicly provided goods and services is vital to this theory, owing to its immediacy to welfare cost calculations. Given the Soviet Union's centralized command economy, with a near absence of private enterprise, this issue is a point of divergence between the analysis of Soviet-type economies and other economies at similar levels of economic development, where price elasticity for publicly provided goods is agreed to be less than -1 .² The economic transition process itself then becomes important in assessing the welfare costs imposed by the country's transition to federalism. This is an important point. Federalism may well be a political institution, but neglecting the private sector economic transition will lead to a biased analysis. To the extent that the private sector reduces dependency on the state, a positive analysis of how best to achieve a federal structure can be undertaken without any compunction.³

It is also generally acknowledged, under the framework of the benevolent government paradigm, that macroeconomic stabilization policies are better managed from the center. We can arrive at this conclusion by considering, for example, the Tiebout hypothesis. The more differentiation is possible among the characteristics of various localities, the more localities there can be in number. Then, given fully open policies, individuals or households will "vote with their feet" by moving to the locality that best suits their preferences and tastes. Although this appears to be unquestionable support for decentralization, the problem is that expecting the Tiebout hypothesis to yield a stable equilibrium seems unfruitful.⁴ However, the assumptions of the hypothesis—zero moving costs, zero externalities of migration, scale economies, and so on, analyzed in Buchanan's theory of clubs⁵—virtually prescribe that stable equilibria for localities will be hard to characterize unless we consider smaller units like suburbs and inner cities where differentiation through self-selection and explicit control can be more subtle. The point, though, is that with a fluid population and open domestic borders, central control over certain expenditures, primarily redistributive in nature, is likely to be more effective because local government expenditures will have a weaker impact on a desired outcome.⁶

The second approach that I mentioned above considers the objective of the state or local governments to be not vastly different from that of various other private sector organizations. An example of this comes from Brennan and Buchanan, who suggest that the central government facilitates contracting between lower-level governments by acting as an enforcer and seeks compensation by partaking in the benefits that ensue.⁷ In addition, various other local governments can impose restrictions as correctionary measures against a local government that dis-sents or reneges on a contract. This has come to be called the "collusion theory."

The emphasis in this approach is on decentralized competition to ensure a limitation on public expenditure by an efficient internalization of costs imposed by local jurisdictions, which might otherwise be party to unproductive activities like pork-barrel agreements and logrolling.⁸ The application of the theory of market-based competition to the analysis of federalism is indeed important, but its validity is based crucially on the institutional context. In other words, it assumes the rules of the game as given parameters. Where the institutional context is less clear, the applicability of the argument becomes more uncertain.

Another classic example of this line of analysis is Niskanen's theory of bureaucratic finance and the "flypaper effect." The latter phenomenon relates to the problem of a lack of equivalence between the manners in which the central government finances the local government budget deficit. It is for this reason that budget financing of lower governments by upper governments has become a hotly debated issue in Russia. In particular, a direct grant tends to induce more expenditure than does a reduction in the tax rate or any other such indirect financing. Niskanen's bureaucrat, who seeks to maximize his bureau's expenditure budget, since his salary directly depends on it, will presumably prefer a direct grant if any other financing mechanism raises the bureau's budget by less.⁹ An indirect raise given to the local residents where the bureau operates is likely to raise the bureau's justifiable expenditures often by much less than the face value of the raise.¹⁰

These two approaches, which I have only briefly introduced with the help of some examples, are indeed very useful ways of analyzing the institution of federalism, even if they were not originally intended for the purpose. However, to this list I wish to add a third, more eclectic approach, which is also potentially helpful in investigating the problems of federalism. Although it undoubtedly draws freely from both of the first two approaches, it concentrates primarily on two subjects—the structure of property rights and the economics of rent seeking in the context of a bureaucratic order. It perhaps is biased more to the latter approach in its essence.

There are three main reasons why I believe this final approach deserves to be treated as separate from the two approaches I have outlined. First, it grants a more unified analysis of politics and production in the public and the private sectors. The primary benefit of this is that the effects of industrial organization on the sphere of politics can be seen more directly, as can, consequently, the effects on center-region bargaining over the distribution of power and economic rent. Second, it allows the study of political maneuvers and tactics adopted by politicians in the center and the regions. This is primarily a political career advancement-based approach. A third reason for the adoption of this approach is that it is particularly well-suited to analyze the dynamic environment of transition economies, wherein the nature of property rights changes constantly, creating equally dynamic incentives in the private and political sectors.

The objectives of government in transition economies are, one could argue, not compatible in rank-order with governments in less dynamic, more stable economies. The following section highlights what circumstances may cause such differences and why they might be important to federalism in Russia.

Russia's Transition Economy

The relationship between the federal government and its regions in Russia has not been studied extensively by many scholars in the field of political economy.¹¹ The facts are unclear at first pass and do not give a very cogent understanding of what the center-region relationship is like in Russia. Cohesion among the regions and between the regions and the center is at best uneven and at worst nonexistent. I have come to believe that the problem is grave and deserves immediate attention.

At the start of the disintegration of the Soviet Union, Russia's effort to make a clean break was boosted by its promising substantial autonomy to the regions. Yeltsin built a strong support base for himself in Russia by encouraging calls for sovereignty from all across Russia, in addition, of course, to the near abroad. He spread the word that the regions should "take as much sovereignty as they could swallow." Therefore, following Russia's June 1990 declaration of sovereignty, such declarations were also made in Kareliya, Sverdlovsk oblast, and Tatarstan, among others. With political power dispersed all over the country, a return to centralized command was avoided, and that served Yeltsin's purpose well indeed.

The problem, at least vis-à-vis fiscal federalism, was worsened by this, plausibly short-sighted, distribution of power away from the center for political leverage. By mid-1993, scores of regions refused outright to remit federal taxes. The federal government had little they could do in retaliation. Co-optation is an essential mechanism of gaining political support in Russia, and federal transfers to the regions made through 1994 were quite possibly intended for precisely this purpose—to co-opt the rebellious regions. Gradually, those transfers were reduced and tax arrears, at least in the richer regions, began to diminish.¹²

However, this is barely one aspect of federalism in Russia. The problem runs deeper. It casts doubt on the degree of control that Moscow really wields over the regions. At its worst, it casts doubt on the very viability of Russia as a nation state. It has grave implications for the effectiveness of economic policymaking in the center and for the nature of politics and bureaucracy in Russia.

The approach to analyzing federalism that I have suggested—property rights systems and the economics of rent-seeking activities—helps in explicitly recognizing the problem of adverse incentives created during the period of transition. By ignoring those realities, any analysis is liable to miss the whole picture. Let me elaborate with the help of the some propositions developed in the following sections.

Nomenklatura and Federalism

The Soviet system of nomenklatura was based on a "catalogue" that listed various jobs in the private and public sectors of the economy that were directly dependent on a particular level of the government bureaucracy. These jobs were particularly valuable because they allowed largely unfettered interaction with productive activity, which subsequently afforded appointees various rent-seeking opportunities. The jobs were often explicitly auctioned for stated prices. However, the primary consideration of the appointees was that the rent-seeking agents have strong loyalties to the individuals that formed the so-called nomenklaturist class. The reason for this appears to be that, although the system had taken deep

roots in the economy over the decades, it was inherently against the law and therefore subject to being uprooted, or at least hindered, by a change in the political agenda of the elite ruling class. That threat from the elite was the Achilles' heel of nomenklatura.¹³

The system of nomenklatura in effect drew up spheres of influence for its members, with explicit and enforced property rights over the appropriation of rent from the productive process. Those spheres of influence were obviously valuable assets, as evidenced by the fact that they were used to bribe and lure the agents. The agents—for example, those placed in key firms—performed regular duties for their appointees to help them further the appointees' political cause. They did

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this understandably grudgingly at times, but they did it all the same. They were bound by what can be termed no less than a *comerta* of the nomenklaturist class. Moreover, these positions were often very beneficial to the agent long after he moved out of it to either retire or be promoted to an even better position in the bureaucracy. As loyalty was a

primary objective, the positions were simply bequeathed to family members or close friends.

The importance of economic rent to the government bureaucracy of Soviet Russia is then perhaps unmistakable. However, it is harder to ascertain the saliency of rent seeking in present-day Russia. The Tiebout hypothesis suggests that the local governments will gain relatively more from controlling economic rent streams if the region under their control can be kept autarkic to the extent they desire. What we can therefore expect in Russia is that decentralization of political control has presumably allowed an opportunity for regional government bureaucracies to realize this objective.

During transition, when sovereignty seemed to score high on every politician's agenda, the nomenklatura manifested itself in a manner that I believe is vital to an analysis of federalism in Russia. The Achilles' heel of the nomenklatura—the elite—self-destructed as the center was plagued by commotion and distraction, which weakened it. That provided an excellent opportunity for the nomenklaturist class to formalize its catalogue of jobs. Central command atomized based on vested political interests and loyalties to the nomenklaturist classes. This was effectively achieved by drawing borders around the spheres of influence of the countries' various nomenklaturist classes, a process that quite understandably caused friction among those opportunists, who were each attempting to maximize and formalize their sphere of influence. It did not help that various nomenklaturist classes had probably limited if any experience in dealing with each other, since in the Soviet Union they dealt directly with agencies of the center, like the Sovi-

et ministries. Therefore, in a politically volatile environment, increasing the size of the bureaucracy to co-opt recalcitrant nomenklaturists yielded a multilayered government that only appears to be a federally decentralized structure.¹⁴

The problem faced by Russia's federal structure arises from something identified more than thirty years ago by William Riker.¹⁵ He suggested that strong central control is an essential component of effective federalism. Riker explained that a federal structure is in fact simply two or more levels of rather autonomous governments governing over a common land and citizenry. For constructive bargaining to occur between levels of government, a strong centralization of the political process is required. If this is not achieved then a peripheralized federalist structure with more indiscriminate power struggles is liable to develop. Each subunit, rather like Niskanen's bureau, attempts to increase its budget by increasing its area of influence. Benefits of a federalist structure are then understandably reduced if wanton decentralized bargaining among subunits for political purposes takes precedence over effectively solving problems of collective action by using a central arbiter or enforcer.

Riker's insight on effective federalism coupled with Voslensky's insight on the weak link of the nomenklaturist class does not work in favor of Russian federalism. The Soviet system of nomenklatura ensured that a market-based and welfare-enhancing federal structure with productive political centralization would not develop in Russia. What would instead result would be small nomenklaturist groups hiding behind administrative units created by a federal governance system.¹⁶

Tactics of Political Control and the Private Sector

If the bureaucracy can control capital movement from and to the region, then this increases the opportunities for the local government to extract economic rent by increasing the interchange with private sector activity. If this is true, then the local government has two rather conflicting goals: it must expand the productive base to maximize return to its rent-seeking activities while simultaneously placing restrictions that discourage its growth. In Soviet times, relative equity of investment levels was maintained among the republics, largely irrespective of the influence exerted by regional political elites, due to the offsetting advantages each republic had to offer in terms of natural resources, availability of skilled labor, and the size of its population.¹⁷ Although I have no evidence showing that this policy carried over to regions within Russia, if indeed such a policy was in place then, approximately equalized rent-seeking macrostructures were in place on a per capita basis. This implies that local governments have potentially even less to gain from opening their regional economies to domestic competitors unless they can encroach on the productive bases of other regions. Therefore, by adopting autarkic policies regional governments hurt not only their relationship with the center by reducing its efficacy in implementing macroeconomic stabilization policies, but also their relationship with other regions as a result of indifference and mistrust of real motives.

Evidence has been found for the fact that mistrust and a general lack of willingness to develop a more transparent relationship exist not along the lines of

regions, but rather along the lines of levels of government. The Russian tax system is based on a revenue-sharing system whereby different levels of government, though with theoretically separate tax bases, share their revenue from most taxes with other levels of government. The notion that bureaucratic co-optation and political control carried over into post-Soviet Russia gets support from the extensive research literature on the Russian tax system. The optimal tax structure should be devised around the essential notion of assigning expenditure responsibilities. This is more important in a heterogeneous society like Russia's, where responsibilities of the government in providing public goods should be devised in active involvement with the population. However, a deliberate fudging of the optimal structure of the expense budgeting has taken place in Russia so that each level of government attempts to apportion responsibility on a different level.¹⁸ This has allowed the revenue-sharing system between levels of government to be unclear and questionably dishonest. Lower levels of the government employ tactics, achieved through a much higher level of association with the private sector than would be efficient or normal even by Chinese standards, to retain economic rent within their territory lest the excess revenue collections of the government prompt any commands for more responsibilities and sharing from bureaucrats above.¹⁹ The notion of defending productive bases for economic rent by adopting autarkic policies is also given further support by observing that increasing the retention rate in revenue collections does not lead to a greater effort in tax collection.²⁰ There is also resistance to changing the existing transitional tax system to that outlined by the framework document "Basic Principles on Taxation in Russia," which would allow only the central government to clearly assign tax bases, lessening the autonomy that subnational governments would have.²¹ In fact, extensive effort is made by all lower levels of government to deliberately undermine any centralization of the tax system by informally and indirectly drafting associates of the state tax service who are sent to the regions to ascertain the accuracy of revenue sharing of tax proceeds.²² The sharing of tax revenue is a way in which the center can exert its influence on the regions, but the regions have successfully managed, to a large extent, to wrest this tool away from the center.

All this implies, in terms of the general public choice framework for analyzing federalism, that regional-level governments are devising strategies, directed at the other levels of government, that help them internalize benefits of tax revenue collection while simultaneously refusing to internalize the costs that come with accepting accountability over expenditure.

From the analysis thus far, it is possible to claim that intergovernmental relationships can then be assessed by looking at the macrostructure of the bureaucracy within each level of government involved in the relationship over time. Nevertheless, some caution is required, since corrupt politicians can be restrained by two factors. On the one hand, there is the upper level of government that can reserve the right to make appointments to lower-level government bureaucracies or impose undesirable changes on the productive bases of the local government in the name of national welfare. Such centralization, in accor-

dance with Riker, would naturally increase the quality of Russian federalism and would require seizing control from lower levels of government. On the other hand, elections can also bring about an uprooting of the corrupt bureaucracy by dissatisfied citizens and interest groups. The manners in which politicians react to these constraints are therefore important in assessing the true nature of inter-regional relationships.

Although there are no formal data on political tactics employed to ameliorate such potential problems, quite a few reports exist that shed some light on the issue. In Primorsky krai, former nomenklaturist elites engaged in a highly scandalous appropriation of economic rent by taking control of the most lucrative private enterprises in the region and consolidating them into a single holding company, of which they became ostensible owners. Although an arbitrary tax system was still in place, takeover of those enterprises gave the bureaucrats direct control over the productive base that they had wished to control through public office in the first place.²³ Direct and plainly unlawful encroachment on the private sector is often combined with blatant violence against individuals who may wish to publicly expose the bureaucratic fraud to higher authorities or to the citizens. This has happened in Primorsky krai as well as in Krasnoyarsky krai, where the governor, Alexander Lebed, cooperated with the allegedly criminal Chernoy brothers and the business tycoon Boris Berezovsky to oust and replace the aluminum tycoon Anatoly Bykov from a controlling position in the region's top metals and energy companies.²⁴ When all else fails, blatant disregard for public opinion is also not uncommon, as was recently demonstrated by the Kaliningrad governor, who was shown on Russian television reprimanding his citizens for making far too many demands and not trying to cope with the times.²⁵ The governors of Kaliningrad and Krasnoyarsk recently also asked for more freedom from the center to devise their own economic reforms²⁶—this when the news media had charged the Kaliningrad government with engaging in smuggling and bootlegging.²⁷

It is also rather easy in most regions to make a mockery of the election process. In spite of reports of rampant corruption and crime in the region, the governors of Kaliningrad and Primorsky continue to be re-elected in every election. Concomitant with the 26 March 2000 presidential election, seven regions in Russia also held gubernatorial elections, in which all seven governors were re-elected, in some cases by margins of over 80 percent.²⁸ Although reports of doctoring the results of elections are less common, what is more common is the political backing of well-known oligarchs implicitly promising riches to the citizens of the region and ensuring only weak opposing candidates, if any, as rivals.

Finally, another common tactic for defending the region's productive base from being subservient to national welfare is creating a sentiment among the citizens that their region is a net donor, be it in terms of natural resources or tax revenue. This, coupled with issues that tend to mobilize voters, such as ethnic differences or unique cultures and histories, forces the upper-level government to concede more autonomy to the region and more discretion in terms of distribution of revenues. The diamond-rich region of Yakutia employed this tactic in extracting a handsome deal from the central government that allowed them near-

ly complete control over the flow of diamonds out of the region.²⁹ Such contracting is also present in natural gas extraction between the centralized natural gas monopoly, Gazprom, and the regions in which it operates natural gas fields and pipelines. Typically, Gazprom develops an administrative unit under the aegis of the local or regional government, which thereafter regulates Gazprom's natural gas field operations and is liable to the region's tax authority.³⁰ This does not seem like a particularly incorrect setup, apart from the fact that it offers the region the benefit of encroaching on Gazprom's activities, either by taxing or by seeking bribes and kickbacks, when an efficient tax system would leave all control over a good like natural gas with the central authorities alone. Natural resources are asymmetrically distributed in a country the size of Russia, and therefore an efficient tax system of first difference (in which the first infraction of a law by any entity prompts legal action) should allow the central government to equalize the difference through its redistributive channels.

The private sector, especially new industries and foreign investors, undoubtedly loses in this game of political control since it reacts to market-based incentives. Because private sector activity often transcends borders mandated by governments at the local or the national levels, the manner in which contracting occurs between the private enterprise and the various levels of governments will be affected by the relationships among these levels of governments.³¹

With rent-seeking opportunities as driving objectives behind the decentralization of the Russian economy and as a vital basis for the Russian brand of federalism, certain problems predictably come to the fore. In contrast to the Soviet economy, wherein production chains were highly centralized and rent seeking by the nomenklaturist class was facilitated by control of a portion of the process, for example through ministries, in the new Russian economy control over the production process often spreads across various regions. That the central government recognizes this problem becomes blatantly obvious when we consider that it maintains significant control of the natural gas and electricity networks that span the whole country and form essential components of almost all production processes, regardless of how remote the region. It achieves this by maintaining a significant stake in Gazprom, which is a large creditor to the electricity monopoly RAO UES. Both firms have prominent politicians on their boards.³²

It is for these reasons that the structure of property rights and contracting among the regions and with the center becomes an important consideration. The center's role becomes even more prominent since it often has a comparative advantage in playing broker between the regions. However, by bypassing the center the regions have more to gain, because not sharing economic rent with the center decreases lower-level accountability.³³ A related problem is that in the case of a division of the productive process among various regions, the externality effects of rent-seeking activities in any one of the regions is accentuated. This should encourage collusion among regions along the lines suggested by Brennan and Buchanan.³⁴ Evidence for this can only be found by studying the entire length of a production process that spans several regions.

Theories of Federalism

The first theory I have discussed in this article suggests why a federal system in Russia can be expected not to develop optimal incentives. It uses Voslensky's insight on the system of nomenklatura to posit that decentralization would result in economic rent seeking based on an atomization of the nomenklaturist class. From a Rikerian perspective, we can expect this to be particularly harmful for federalism in Russia. Political bargaining between levels of governments shifts from the field of productive, market-based welfare maximization to decentralized internal strife among the regions and also with the center over a bigger share in the pie. This may occur either geographically, through the many tiers of government, or even in terms of revenue and expenditure sharing, as the extensive literature on Russian tax reform seems to suggest. That atomization is debilitating to economic growth has been suggested by Zhuravskaya in comparison with China, where the "federal" structure is indeed still highly centralized.³⁵ For economic rent seeking in terms of corruption, which is an effective indicator of government failure, Shleifer and Vishny have suggested how an atomization of the bureaucracy from centralized monopolistic control can, in the limit, lead to an infinite total bribe collection due to a lack of consideration for synergy effects with other bureaucracies.³⁶

The second argument suggested is derived from the notion of increased political control over private sector activity in a situation where former nomenklaturist classes have a vise-like protective grip over the productive base they employ for rent extraction. They use various maneuvers and tactics—some more illegitimate than others—to maintain their control. Atomization of nomenklatura leads to more benefits for the members of the now fractionalized bureaucracy at the expense of the private sector and consequently economic growth. However, this plausibly creates increased competition for these lucrative bureaucratic positions. Therefore, politicians must employ various gambits to ensure that they remain in power.

There is ample evidence, albeit either rather theoretical or overtly particular, that the ruling class has vested political interests in maintaining a decentralized federal system. They have a substantial amount to lose if the system collapses, for instance, by strong central control that encourages the rule of law, which separates public office from private enterprise effectively. To prevent such disasters, lower-level government bureaucrats have employed tactics ranging from violent to fraudulent to ensure that they remain in office. I have still not addressed adequately why citizens would agree to decentralized rule by controlling bureaucrats. Although political mobilization through inciting ethnic or cultural concerns has

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been mentioned as an example of politicians' capitalizing on social externalities to maintain control, rational citizens, and particularly organized interest groups, are liable to ascertain welfare loss exacted by dishonest politicians and react accordingly. Note also that maintaining subnational autarky in terms of mobility of labor is much harder than controlling the flow of other resources. This apparent problem of complacency or resignation actually arises from a classic, externalities-based argument. The problem is in fact worse than these theoretical arguments suggest. This is due to the inefficient inertia built into a federal system with relatively high decentralized control.

The inertia arises because citizens actually prefer to live in a region with strong local governments when central control in a federalist nation is weak or disorganized. A stronger local government is more adept at exporting costs such as tax burdens, importing benefits such as infrastructure development, and retaining revenues.³⁷ To a large extent, the objectives of a strong politician who wishes to expand and protect his or her productive base are in accord with the wishes of the citizens of that state. This explains why seemingly corrupt and manipulative governors or other ruling-class elite are repeatedly re-elected.

Possible Solutions

There are, in general, three mediums of change in a decentralized, exploitative federalist system. First, there is the central government, or, in a multilayered government, the upper-level government. The central government is an obvious loser in a decentralized system due to the economic rent it must forgo to local governments that employ tactics to obfuscate central government-level redistributive initiatives conducted in their regions. This was evidenced by Shleifer and Treisman *vis-à-vis* the corrupt tax officials sent by the central government to the regions.³⁸ The second source of change is other levels of government. In accordance with the collusion hypothesis posited by Brennan and Buchanan, all the various levels of government—from central to local—are interested in colluding against government bureaucracies that impose negative externalities on them through their policies, for instance, by exporting tax burdens.³⁹ Their argument also lends support to the first medium mentioned above—the central government—for they argue that it is the central government that gains the most by reserving the right to be the sole contract enforcer in the system. Usurpation of this power by greedy lower-level governments is an incentive for the central government to react strongly. The third mode of reform for the system is the citizenry. Rose-Ackerman suggested that even citizens who want to export costs and import benefits have an incentive to have a reasonably strong central government that keeps the discretionary powers of the lower-level government in check.⁴⁰

These three sources, in some manner, all relate back to Riker's insight that a federal structure functions best with a strong political center. The policy of co-opting the powerful regional ruling elite has been identified as the cause for the lack of central government-level initiative. However, in the tumult of transition, the fledgling central government was indeed no match for the atomized nomenclaturist class that has established its hold over the economy through the years.

Co-optation was perhaps a rational response by the central government, given the political realities at the time. With more stability in the longer run emanating from macroeconomic stabilization, which indeed appears to be well on its way, and a more consolidated party system that can recentralize the atomized nomenklaturist classes, the central government can hope to recover lost ground.

Conclusion

I began this article with an outline of two leading strands of analyses of federalism. I was doubtful of their applicability to the case of Russia for the simple reason that they do not directly address the problem of evaluating a federal system in an economy in transition from a centrally planned command economy to a market-based one. I therefore deemed it necessary to introduce a new approach that explicitly addressed one of the most well known problems that plagues the Russian economy: how to curb the political sector's excessive control over private enterprise, potentially by reforming the bureaucracy or simply circumventing the problem through reform of the legal and property rights systems.

The good news is that indeed no new and novel approach seems to be required to evaluate the federal system in the transition economy of Russia. Brennan and Buchanan and Riker contributed some of the most important insights into the problem of an inefficient Russian federal structure with arguments that fit neatly into the existing literature.⁴¹ The literature also provides us with broad solutions to the problem that indeed seem to identify flaws in the system. This is truly encouraging.

However, there surely is a need for a realization of the political realities in the Russian economy. I develop one of my most important claims in this article using a concept of bureaucratic organization that is indeed only peripheral in the existing political economy literature on federalism. Continuing to neglect this would indeed hinder the analysis of federalism in Russia.

The current state of Russian federalism is inefficient due to the imperfect incentives it generates and sustains in the public and private sectors. However, with a keen and simple realization of the political realities that developed during transition, even the existing literature on the political economy of federalism provides us with insights on the case of Russia and points out avenues for a change for the better.

NOTES

1. William Oates, *Fiscal Federalism* (New York: Harcourt Brace, 1972); and William Oates, "An Economist's Perspective on Fiscal Federalism," in *The Political Economy of Fiscal Federalism* (Lanham, MD: Lexington Books, 1979).

2. See chapter 17 in Dennis C. Mueller, *Public Choice II* (Cambridge: Cambridge University Press, 1989), for an elaboration of this point.

3. This point is discussed very nicely, using a comparison between early reforms in Russia and China, in Kevin Murphy, Andrei Shleifer, and Robert Vishny, "The Transition to a Market Economy: Pitfalls of Partial Reform," *Quarterly Journal of Economics* 107, no. 3 (1992).

4. C. M. Tiebout, "A Pure Theory of Local Expenditures," *Journal of Political Econ-*

omy 64, no. 5 (1956): 416–24.

5. James M. Buchanan, “An Economic Theory of Clubs,” *Econometrica* 32, no. 125 (1965): 1–14.

6. R. A. Musgrave, for example, identifies this problem in relation to taxation policy. He suggests that only tax bases that are immobile should be assigned to lower authorities. Where high differences in the marginal tax rate exist on mobile bases, redistribution of tax revenue should be centralized to avoid large deadweight loss. In Russia, though tax bases are identified and largely conform to this general guideline, local authorities have the liberty to impose ad hoc taxes. See R. A. Musgrave, “Who Should Tax Where and What,” in *Tax Assignment in Federal Countries*, ed. Charles McClure, Jr. (Canberra, Australia: ANU Press, 1983).

7. G. Brennan and James M. Buchanan, *The Power to Tax: Analytical Foundations of a Fiscal Constitution* (New York: Cambridge University Press, 1980).

8. For a detailed discussion, see James M. Buchanan and Gordon Tullock, *The Calculus of Consent* (Ann Arbor: University of Michigan Press, 1965).

9. William A. Niskanen, “The Peculiar Economics of Bureaucracy,” *American Economic Review* 57, no. 2 (1968): 293–321.

10. See David N. King, *Fiscal Tiers: The Economics of Multi-Levelled Government* (Boston: Allen and Unwin, 1984), for an elaborate discussion on the flypaper effect.

11. A number of studies on aspects, such as taxation policy, of federalism and center-region relationships do exist. However, studies on federalism in Russia along the lines of the approach I suggest are rare. Some exceptions are Andrei Shleifer and Daniel Treisman, *Without a Map: Political Tactics and Economic Reform in Russia* (Cambridge: Massachusetts Institute of Technology Press, 2000), and Daniel Triesman, *After the Deluge* (Ann Arbor: University of Michigan Press, 1999).

12. Shleifer and Treisman, *Without a Map*.

13. Although the Achilles' heel of nomenklatura was the elite ruler, it was also implicit support from higher authorities that made the system possible. This was done by turning a blind eye to some appropriation of rent in return for conformity to the central plan. To this extent, even in the centralized command economy of the Soviet Union, a policy of co-optation was in place. This explains the persistence of the system even when the objectives of the elite ruler and nomenklaturist class were often at odds. For a more careful discussion, see Mikhail Voslensky, *Nomenklatura* (Garden City, NY: Doubleday, 1984), and Jan Winiacki, “Why Economic Reforms Fail in the Soviet System—A Property Rights-Based Approach,” *Economic Inquiry*, April 1990.

14. See Christine I. Wallich, “Intergovernmental Finances: Stabilization, Privatization, and Growth,” in *Russia and the Challenge of Fiscal Federalism* (Washington, DC: World Bank Publications, 1994), for a good survey of these various levels of government.

15. William Riker, *Federalism: Origins, Operations, and Specifications* (Boston: Little Brown, 1964).

16. In my article “Corruption: Theory and Evidence through Economies in Transition,” *International Journal of Social Economics* 27, no. 12 (2000), I explain why an atomization of a bureaucratic structure can lead to an increase in rent-seeking activities using a more formal treatment.

17. Donna Bahry, *Outside Moscow* (New York: Columbia University Press, 1987).

18. Jorge Martinez-Vasquez, “Expenditures and Expenditure Assignment,” in *Russia and the Challenge of Fiscal Federalism* (Washington, DC: World Bank Publications, 1994).

19. Ekaterina V. Zhuravskaya, “Incentives to Provide Local Public Goods: Fiscal Federalism, Russian Style,” Stockholm Institute of Transition Economies and East European Economies, SITE Working Paper 153, 2000.

20. In a separate paper, I suggest that the tax system, and in general nonmonetary transactions including barter, can be related to deliberate obfuscation of political control over productive activity.

21. Robert Bahl, "Revenues and Revenue Assignment: Intergovernmental Fiscal Relations in the Russian Federation," in *Russia and the Challenge of Fiscal Federalism* (Washington, DC: World Bank Publications, 1994).
22. Shleifer and Treisman, *Without a Map*.
23. Peter Kirkow, "Regional Warlordism in Russia: The Case of Primorskii Krai," *Europe-Asia Studies* 47, no. 6 (1995): 923–47.
24. See Neela Bannerjee, "Helter-Smelter: Amid Russia's Turmoil, UK Firm Wins a Slice of Nation's Aluminum," *Wall Street Journal*, 28 January 1997. Also see Reuters, "Russian Businessman Extradited From Hungary," 21 April 2000.
25. NTV News Report, *Segodnya*, March 2000
26. See Jennifer DeLay, "Russia's Federal System—Is Bigger Really Better?" *Russia Today*, September 1998.
27. See Vladimir Zhukov, "Kaliningrad is Hub for Europe's Booze Smugglers," *Agence France Presse*, 21 January 2000.
28. RTV Report, *Federatsiya*, 1 April 2000.
29. Charles E. McClure, "The Sharing of Taxes on Natural Resources and the Future of the Russian Federation," in *Russia and the Challenge of Fiscal Federalism* (Washington, DC: World Bank Publications, 1994).
30. See Gazprom's Web site at www.gazprom.ru for more information.
31. There is extensive evidence on the inefficiencies of bureaucratic control with regard to new private sector enterprise activity. The Russian/EU Center for Economic Performance reported that foreign investors in Russia are discouraged and concerned by the endless approvals required for their projects on the federal, regional, and local levels. Furthermore, "the vagueness of existing laws can lead to differing interpretations and conflicting requirements on the different levels." See U.S. Department of Commerce, National Trade Data Bank, 6 May 1999, available at www.stat-usa.gov. Andrei Shleifer reports that compared to Warsaw, small enterprises in Moscow were burdened with far more regulation by officials seeking bribes in return. See "Government in Transition," *European Economic Review* 41, no. 3–5 (1997): 385–410.
32. Among others, the minister of fuel and energy and the first deputy finance minister sit on Gazprom's board. Anatoly Chubais heads RAO UES.
33. For a theoretical treatment and overview of this argument, see Paul Seabright, "Accountability and Decentralisation in Government: An Incomplete Contracts Model," *European Economic Review* 40, no. 1 (1996): 61–89.
34. Brennan and Buchanan, *The Power to Tax*.
35. Zhuravskaya, "Incentives to Provide Local Public Goods."
36. Andrei Shleifer and Robert W. Vishny, "Corruption," *Quarterly Journal of Economics* (August 1993).
37. For a formal analysis of this claim, see Susan Rose-Ackerman, "Does Federalism Matter? Political Choice in a Federal Republic," *Journal of Political Economy* 89, no. 1 (1981): 152–65.
38. Shleifer and Treisman, *Without a Map*.
39. Brennan and Buchanan, *The Power to Tax*.
40. Rose-Ackerman, "Does Federalism Matter?"
41. Brennan and Buchanan, *The Power to Tax*, and Riker, *Federalism*.