



# Constitutions, regulations, and taxes: Contradictions of different aspects of decentralization

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## ABSTRACT

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The paper confronts different aspects of decentralization: fiscal decentralization, post-constitutional regulatory decentralization, and constitutional decentralization – using a single dataset from the Russian Federation of the Yeltsin period as a politically asymmetric country and a variety of indicators. It finds no robust correlation between different decentralization aspects; moreover, three processes of devolution appearing in the same country at the same time seem to be driven by different (though partly overlapping) forces. Hence, a specific aspect of decentralization is hardly able to serve as a proxy for another one or for the overall decentralization process. *Journal of Comparative Economics* 38 (4) (2010) 395–418. Frankfurt School of Finance & Management, Sonnemannstrasse 9-11, 60314 Frankfurt/Main, Germany; Russian Academy of Sciences, Moscow, Russian Federation.

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## 1. Introduction

One of the main problems for the empirical literature on decentralization, its driving forces and economic impact, is that decentralization is really difficult to measure. The traditional indicators like retention rates or subnational share of public expenditures have been discussed in the literature and thoroughly criticized (Ebel and Yilmaz, 2002). Specifically, bringing theory of fiscal federalism to data is difficult because there is a multitude of aspects of decentralization, which do not necessarily map into each other. To start with, one should differentiate between the constitutional and the post-constitutional decentralization. Following the Buchanan and Tullock's (1962) approach to the constitutional and post-constitutional decisions, the post-constitutional decentralization reflects the *outcomes* of the political process, once the constitutional rules are set, rather than the rules themselves. Or, stated otherwise, the constitutional decentralization describes the ability of regional administrations to make independent decisions (which is recognized by the central government, see Schneider, 2003), while the post-constitutional decentralization describes the consequences of this allocation of authority for financial flows and regulations.

In addition, however, both constitutional and post-constitutional devolution can differ in individual functional areas of the government and economic policy. The distinction between the constitutional and the post-constitutional levels is particularly simple in fiscal matters: the constitutional decentralization implies the right of regions to independently decide on revenues and expenditures of their budgets; the post-constitutional decentralization, however, means just the allocation

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of funds between center and regions, which may be decided by the central government. The situation is slightly more complicated, if one looks at the regulations. The constitutional decentralization, once again, means the allocation of decision-making rights on standards and norms for economic activity. However, this allocation may be different from the “real” significance of regional and federal regulations for economic agents. For example, it is possible that one of the parties (either center or states) is more active in filling its “regulatory niche” with acts and norms, than the other.

The aim of this paper therefore is to explicitly confront different concepts of decentralization using a single dataset. In spite of the obvious importance of the topic, the literature comparing different dimensions of decentralization is very small (Treisman, 2002; Schneider, 2003; Blume and Voigt, 2008; Martinez-Vazquez and Timofeev, 2009) and mostly focuses on international settings. However, data compatibility across nations adds an additional dimension to the measurement problem. Hence it is reasonable to look at different aspects of decentralization and their origin using the *intra-national* variation of decentralization, which, however, to my knowledge has never been considered empirically before for this purpose. The objective of this paper is rather positive than normative: first, I try to establish a correlation between different aspects of decentralization, and second, look at the driving forces determining the decentralization outcomes. From this point of view the paper aims to contribute to the growing empirical endogenous decentralization literature (e.g. Panizza, 1999; Cerniglia, 2003; Arzagli and Henderson, 2005; Letelier, 2005; Stegarescu, 2006; Feld et al., 2008), attempting to perform a positive analysis of factors determining (various) degrees of decentralization.

It is difficult to find a reasonable empirical playground for this exercise, mostly because decentralization beyond simple allocation of revenues and expenditures is very hard to quantify. This paper takes advantage of the process of asymmetric devolution in the Russian Federation in the 1990s, and uses Russia as the laboratory for comparing different aspects of decentralization. During this period individual regions achieved different levels of devolution through both bargaining with the federal center and unilateral activities, including introduction of legal norms directly contradicting federal legislation and manipulations with tax collection. On the other hand, Russia remained formally a highly centralized federation, with exclusive authority on the federal level in many areas of regulation, as well as in fiscal affairs. In this paper I use several proxies to measure the degree of asymmetric devolution achieved by individual regions in three main areas: constitutional decentralization, post-constitutional fiscal decentralization and post-constitutional regulatory decentralization.<sup>1</sup>

The main finding of the paper is that three dimensions of decentralization seem to be largely unrelated to each other; moreover, different factors identified in the theory are at work for different aspects of decentralization. The only robust correlation I find is between regulatory decentralization and degree of devolution in regional constitutions; however, even this result is simply driven by a small group of ethnic republics. It is necessary to point out that it does not follow unambiguously from the theoretical reasoning that different dimensions of devolution should be correlated. On the one hand, different preferences and rents in different policy areas could lead to different levels of decentralization. On the other hand, correlation is likely to occur as a consequence of bargaining, where different aspects of decentralization become subject to package deals and therefore the outcomes turn out to be interdependent. The results of this paper, nevertheless, are relevant, first, because our knowledge of interrelation of dimensions of decentralization is limited (and hence it is difficult to confront any theoretical result with reality), and second, because of somewhat simplistic treatment of decentralization in many empirical papers using just one “true” measure of decentralization. The latter could be justified if the dimensions of decentralization were correlated – so, an empirical investigation seems to be of interest.

The paper is organized as follows: The second section briefly considers the design of the Russian federalism and presents different dimensions of decentralization. Section 3 looks at their correlation. Section 4 focuses on determinants of endogenous decentralization in Russia and the econometric problems of the analysis. Section 5 reports the main results with respect to the driving forces of decentralization. 6 summarizes and discusses the results, and the last section concludes.

## 2. Measuring the dimensions of decentralization in Russia

The development of the Russian asymmetric federalism has already been subject to numerous studies in both economics and political science. First, the basic elements of the asymmetry were already inherited from the Soviet period: the federation still consists of national republics, administrative units (oblast or krai) and autonomous okrugs. Although in the early 1990s the situation was quite different, the currently valid constitution of 1993 proclaimed an identical status of all “subjects of the Federation” (the official designation of all regions regardless of their status). However, previous norms, as well as informal bargaining processes granted the national republics special privileges, and, on the opposite, restricted the power of most autonomous okrugs. Second, the asymmetric federalism in the 1990s appeared from the bilateral and multilateral negotiations between the regions and the center (Stoner-Weiss, 1998). Third, the federal law (acts of the parliament and also presidential decrees) was also used to give additional authorities to regions. Finally, the key component of asymmetry were the unilateral activities of the regions: manipulations with the tax retention rates and the so-called “war of laws”, i.e. introduction of regional legislation directly contradicting the federal acts. As a result, Russian regions obtained significantly different degrees of autonomy, resulting into substantial differences of regional legal regimes and economic policies (Polishchuk, 2001).

As already mentioned, this paper looks at three dimensions of decentralization in Russia: post-constitutional fiscal decentralization, post-constitutional regulatory decentralization and constitutional decentralization. To start with, the **fiscal**

<sup>1</sup> In what follows I will use the term “fiscal” and “regulatory” decentralization just to describe the post-constitutional matters.

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