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Fiscal federalism in rentier regions: Evidence from Russia ☆

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When does sub-national fiscal autonomy prompt regional growth and recovery and, under what conditions, does it have adverse effects? We argue that unearned income streams, particularly in the form of revenues from natural resource production or from budgetary transfers from the central government, transform regions dependent on these income sources into rentier regions. Governments in these regions can use local control over revenues and expenditures to shelter certain firms, i.e., natural resource producers or loss-making enterprises, from market forces. Using fiscal data from 80 Russian regions from 1996 to 1999, we test this hypothesis in both cross-sectional and panel specifications. Our results indicate that tax retention, which is a proxy for fiscal autonomy, has had a positive effect on regional reform and investment since the break-up of the Soviet Union. However, we also find that this effect decreases as rentable income streams to regions increase. *Journal of Comparative Economics* **33** (4) (2005) 814–834. Edmund A. Walsh School of Foreign Service, Georgetown University, 37th & O Streets, NW, Washington, DC 20057, USA; The World Bank, Washington, DC 20433, USA.
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1. Introduction

The ability of rulers to tax local capital arbitrarily can limit significantly new investment and economic growth. By contrast, stable and predictable tax policies have often presaged historically the spread of the rule of law and the rise of modern capital markets (North and Weingast, 1989). For theorists such as Madison (1941) and Montesquieu (1989), the separation of powers, not merely between branches of government, but between levels of government provides a constitutional check on the capacity of central authorities to expropriate local wealth. As Madison understood, governments at all levels are capable of expropriation; a fiscal division of powers between central and sub-national government is necessary to constrain the powers of each. Thus, a potential consequence of fiscal federalism is to afford sub-national governments incentives to promote local economic growth.

Following the massive fiscal decentralization in Russia in the early 1990s, economic reform and recovery has varied widely across sub-national regions. As the regional governments began to exert greater authority over local resources, enterprises, and fiscal policy, the federal government's ability to police the common market came under considerable strain. Although several regions have liberalized their economies, enforced hard budget constraints, and protected private property, others have actively resisted these reforms despite efforts in recent years to re-assert federal authority.

The diverse Russian experiments in decentralization afford an opportunity to understand the conditions under which federalism promotes local reform and growth. This paper identifies some of the conditions under which federalism is, alternatively, market-preserving or market-subverting in the Russian Federation. Our argument is an extension of the rent-seeking vs. reform discussion found in models of self-interested governments by Dalmazzo and de Blasio (2001) and Esanov et al. (2001) applied to Russian regions. Our central premise is that governments face a choice between appropriating rents and protecting investors. Because local firms' tax and wage payments are the main sources of regional revenue and employment, greater fiscal autonomy may encourage local governments to limit their own rent-extraction from these firms. However, we posit that, where regional economies depend less on locally-generated revenues and more on appropriable rents from resource extraction or from budgetary transfers from the central government, the fiscal incentives to protect investors disappear rapidly and regional governments are more likely to pursue these rent-seeking opportunities and use firms as sources of political benefits. In sum, we hypothesize that those regions that retain a greater share of locally-generated taxes will be more likely to reform and grow and that the effect of fiscal autonomy on regional economic performance will be declining as appropriable rents expand. Cross-regional and regional panel data from 80 Russian regions support these arguments.

The next section outlines our basic argument. Section 2 summarizes the evolution of intergovernmental fiscal relations in Russia. Section 3 examines the effects of rentierism on regional reform and economic performance. Section 4 presents our findings from cross-sectional data. Section 5 extends these results by correcting for possible endogeneity and by examining these relationships in panel data. The conclusion draws policy implications for continuing reforms of inter-governmental relationships in Russia and presents a brief comparison of Russian and Chinese reforms.

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