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Incentives to provide local public goods: fiscal federalism, Russian style

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Abstract

Based on a unique data set on Russian city budgets, this paper shows that revenue sharing between regional and local governments provides local governments with no incentive to increase tax base or provide public goods. Any change in local government's own revenues is almost entirely offset by changes in shared revenues. This leads to governmental over-regulation of private businesses. It is shown that fiscal incentives are a determinant of the formation of private business and the efficiency of public goods provision. The Russian federalism is compared to the Chinese federalism, where fiscal incentives reputedly are stronger in many provinces.

Keywords: Federalism; Russia; Local government; Transition

JEL classification: H11; H41; H71; O57; P35

1. Introduction

The performance of the Russian economy stands in striking contrast to the performance of several other countries in Eastern Europe and Asia that have also undertaken economic reforms. Real Russian GDP had been declining for 8 years and stabilized in 1997[1] for a short period of time, whereas Poland and China, for

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[1]Source: Russian Economic Trends (1998).

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example, have benefited from continued high growth. This paper argues that inefficient inter-governmental relations are a possibly important reason why Russia lags behind other countries in economic growth. In particular, this paper provides evidence that the structure of revenue sharing between regional and local governments affects governments' incentives to foster business growth and to provide public goods efficiently.

I use a unique data set on Russian city budgets to show that any change in a local government's own revenues is almost entirely offset by an opposite change in shared revenues. Local governments are unable to benefit from an increase in the local tax base, and therefore lack a revenue incentive to expand the tax base. What are the consequences of the magnitude of fiscal incentives? I build a simple model to illustrate that if fiscal incentives are strong, i.e. if an increase in the local tax base results in a nearly equal increase in budgetary revenues, then governments bear financial costs in terms of foregone taxes when they over-regulate or restrict business. In contrast, if fiscal incentives are weak so that the local government's ability to increase its marginal revenue by increasing its tax base is close to zero, then budget revenues are not affected by changes in governmental policy towards business. Economically unjustified political intervention into business, such as excessive regulation, adversely influences entrepreneurial activity and lowers the governmental tax base.[2] In a system with stronger local fiscal incentives, one should observe more benign regulation, and higher growth compared to a system with weaker fiscal incentives. In addition, stronger fiscal incentives should lead to higher efficiency in provision of public goods, because a smaller portion of public expenditures is wasted.

Having shown that fiscal incentives are weak in Russia on average, I empirically examine their consequences. Firstly, I provide some evidence that the strength of fiscal incentives affects private business formation. Secondly, I show that the efficiency of public spending at the local level increases with local fiscal incentives. For each city and year I gauge strength of fiscal incentives by a binomial indicator of the presence (or absence) of crowding-out of changes in own revenues by changes in shared revenues. I then estimate how the variation in the strength of fiscal incentives helps to predict variation in outcomes of public goods provision and formation of private businesses.

My approach rests on the theory of 'market-preserving federalism'.[3] This literature stresses the importance of the government officials' fiscal and political incentives for economic growth. Contributors to this literature (e.g. Oi, 1992, 1994; Montinola et al., 1995; Qian and Weingast, 1996, 1997; Jin et al., 1999) argue that the Chinese fiscal reform of the early 1980s until 1994 gave local governments incentives to pursue local economic growth and possibly created a

[2] See Boycko et al. (1995) and Johnson et al. (1997).

[3] For a survey of this literature, see Qian and Weingast (1997).