Pathologies of Federalism, Russian Style: Political Institutions and Economic Transition

Rui J. P. de Figueiredo, Jr. and Barry R. Weingast*

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1. Introduction

Successful transition to a market economy requires creating the appropriate incentives for governments at all levels to foster rather than control markets. Economists have long agreed that getting "prices right" through appropriately structured markets is essential to giving economic agents appropriate incentives. What they typically neglect is the parallel problem for government: that political institutions must be appropriately structured so that the governments have incentives to pursue policies that foster growth rather than rent-seeking, market intervention, and corruption. Put another way, economists have a mature theory of economic development, but lack the parallel theory of political development.

*Assistant Professor, Haas School of Business and Department of Political Science, University of California, Berkeley; and Senior Fellow, Hoover Institution, and Ward C. Krebs Family Professor and Chair, Department of Political Science, Stanford University. The authors thank Maite Careaga, Scott Gehlbach, John Litwack, Douglass North, Yingyi Qian, and Daniel Treisman for helpful comments.

A critical aspect of political development concerns how to structure the political game so that all the players have incentives consistent with improving social welfare. These players include not only economic agents, such as enterprise managers, but also political officials and consumer/citizens.[1]

We investigate this general question in the context of federalism, with a focus on the Russian Federation. To this end, we develop a theory of comparative federal economic performance based on how the structure of federalism provides incentives for political officials at all levels of government.

Federalism is of interest for several reasons. First, a world-wide trend toward decentralization is underway, attracting considerable interest among political scientists and economists.[2] Second, for the last three centuries, the richest nation in the world has been federal; namely, the Dutch Republic from the late sixteenth through mid-seventeenth centuries; England from the late seventeenth to the mid-nineteenth centuries (a de facto federal state); and the United States from the late nineteenth century to the present. Similarly, modern China, a de facto federal state, has also experienced sustained growth for over twenty years. In contrast, many federal states have fared much more poorly, including India, the large Latin American federal states of Argentina, Brazil, and Mexico, and modern Russia. How do we account for such large differences in economic performance?

Our first observation is that federalism is not a single system with a single tendency (Shaw 1997). Federal states instead comprise a category of systems whose political and economic properties

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[1]Political scientists have a rich and well-developed literature on political development. Many classics have been assembled in Weiner and Huntington (1987). More recent work includes Bates (1981,2001), Haggard and Kaufman (1995), Nelson (1990), Przeworski (1991) and Przeworski et al (2001).

[2]Recent studies by political scientists include: Garman, Haggard, and Willis (2001), Jones, Sanguienetti and Tomassi (2001), Montinola, Qian, and Weingast (1995), Rodden (2000), Solnick (1995), Stepan (1997), Treisman (2001), and Weingast (1995).

vary widely. It is therefore inappropriate to speak of the tendencies or properties of federalism per se, as so often occurs in the literature. We do not believe that it is meaningful to ask whether federal systems have greater corruption, inflation, economic growth, or budget deficits than non-federal states. As we argue below, some types of federal systems promote economic growth and macroeconomic stability while others foster corruption and rent seeking.[3]

Federal systems differ across a range of dimensions, depending in large part on the types of policies that are assigned the various levels of government and the types of incentives created for each level of government officials. The purpose of this paper is to develop a comparative theory to predict differential federal economic performance. The theory shows why some federal systems experience sustained growth, including the richest economy in the world, while others remain poor and exhibit low growth.

Our comparative theory of federalism begins with an ideal type of federation called *market-preserving federalism*, originally outlined in Weingast (1995) and, Montinola, Qian, and Weingast (1995). Market-preserving federalism distinguishes four dimensions that differentiate federal systems. In a market-preserving federal system, subnational governments have primary regulatory authority over their economy and face a common market and hard budget constraint; there is also institutional protection for the federal arrangement. These conditions generate the types of effective federal systems studied in the economics literature. As emphasized by Tiebout (1956), Brennan and Buchanan (1980), Oates (1972), and Inman and Rubinfeld (1997), market-preserving federal systems are likely to exhibit competition among subnational governments that moves them to foster good

[3]We do not argue against statistical tests of federalism, as in Treisman (1999) or Zhou (1999). Rather, we argue that these tests should differentiate among different types of federal systems rather than lumping all federal systems together as one type.

economic outcomes. Of course, achieving the benefits of this competition also requires (in parallel with the condition for the common market) that the center police various attempts by the states to free ride or create common pool problems (see, e.g., Porterba and von Hagen 1999, Rodden 2000, and Sanguinetti 1994).

Market-preserving federalism provides a range of incentives for government officials to foster economic prosperity. First, fiscal incentives imply that subnational governments prosper in parallel with their local economies. Second, the common market condition fosters factor and product mobility. This condition prevents subnational governments from using internal trade barriers to insulate its firms from market competition. Further, because the barriers put local firms at a market disadvantage relative to firms from other jurisdictions, the common market also prevents them from attempting to impose costly market distortions to benefit interest groups. Finally, the hard budget constraint makes fiscal imprudence very costly.

Although the theory of market-preserving federalism provides a useful starting point, a number of additional steps are necessary to develop a truly comparative theory of federalism. The theory of market-preserving federalism has been presented as an integrated package that is normatively superior to other forms of decentralization. This approach, however, belies the fact that when federations violate the principles of market-preserving federalism, they can exhibit enormous variation in both the types of political economic failures and economic performance that those breakdowns entail.

To that end, this paper extends the ideal type of market-preserving federalism to a theory of federalism. In particular, we outline the political economic outcomes – such as inflation, corruption, industrial policy, and policy innovation – that combinations of the principles of market-preserving

federalism effect. This allows us to characterize a number of different "federal pathologies" that occur when different combinations of the principles are present. The theory therefore, allows us to distinguish between multiple types of federations.

We apply our framework to federalism, Russian style. The analysis reveals a sufficient range of federal pathologies that we call Russia's system, following Slider (1997), *market-distorting federalism*. This characterization follows in large part because Russian federalism violates every major principle of federal design. Put simply, federalism, Russian style, has two major shortcomings that cause it to fail to provide regions with adequate incentives to foster local economic prosperity; indeed, it provides just the opposite incentives. First, it fails to conform to the classic economic principles of federalism associated with Hayek (1939), Musgrave (1959), Oates (1972), and Tiebout (1956). Political expediency and financial distress have guided the center's delegation of policy authority rather than a logic of administrative comparative advantage. The center attempts far too much control of the regions, with several consequences. Russia suffers significant losses due to Moscow's attempts to impose a "one-size-fits-all" policy on the regions; while Moscow's inability to impose its will has lead to a haphazard system by which the regions have asserted a degree of informal autonomy that skirts Moscow's control (Lavrov, Litwack, and Sutherland 2000, OECD 2000).

Second, at the local level, fiscal incentives reward regions that make trouble for Moscow and penalize those that succeed in fostering economic growth (Solnick 1995, Shleifer and Treisman 2000, Triesman 1999). The absence of a common market and hard budget constraints allow subnational governments to pursue rent-seeking, corruption, and market intervention. Finally, the center retains too much power over the institutions of federalism, and they have remained in flux.

In combination, these two features of Russian federalism generate a significant degree of distrust between center and regions. The result is a striking lack of cooperation between center and regions, yielding considerable losses in social surplus. Put simply, design problems with federalism, Russian Style, produce standard federal pathologies rather than foster economic growth. Although officials at the center have long embraced the rhetoric of economic reform, they have failed to provide subnational government officials with a political structure that gives them incentives to foster economic growth. These institutional design flaws are not merely one among many problems hindering Russia's transition, but one of the main problems.

This paper proceeds as follows. Section 2 develops the comparative theory of federalism, while section 3 discusses the theory's implications for economic performance. Section 4 discusses the theory's veracity by applying the theory to a range of federations. Section 5 applies the framework to Russia with a brief comparison to modern China. Our conclusions follow.

2. A Comparative Theory of Federalism

To understand the comparative theory of federal performance, we start with the conditions for market-preserving federalism outlined in previous research (see, e.g. Montinola, Qian and Weingast 1995; Weingast 1995; Qian and Weingast 199*).[4] The combination of conditions that hold for a federation determine its performance.

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[4]Note that this implies that the defining characteristic of federalism is not whether a nation calls itself federal – "de jure federalism" – but whether it meets various conditions. Thus, we classify eighteenth century England and modern China as federal despite not being de jure federal states, whereas Mexico in the 1980s, a de jure federal state, was more akin to a unitary state.

All federal systems decentralize political authority, so a defining characteristic of federalism is:

(F1) **Hierarchical Jurisdictional Autonomy.** There exist a hierarchy of governments with a *delineated scope of authority* so that each level of government has its own policy domain.[5]

Federal systems differ enormously, however, in how they allocate power among levels of government. The following conditions characterize the different ways in which federal states allocate power among national and subnational governments.

(F2) **Subnational autonomy.** Do the subnational governments have a high degree of *authority over the local economy* in conformity with standard economic assignment principles?

(F3) **Common market.** Does the national government have the authority to police the *common market*?

(F4) **Hard budget constraint.** Do all governments, especially subnational ones, face *hard budget constraints*?

(F5) **Institutionalized authority.** Is the allocation of political authority *institutionalized*?

To make the discussion of these conditions manageable, we ignore many subtleties and simply assume that each condition is binary; in other words it either holds or does not.[6] We can thus characterize different federal systems as to which conditions they satisfy, ranging from F1 alone to F1 along with some of the other conditions. This section describes the meaning of each condition, while the next discusses their economic implications.

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[5]This definition is in the spirit of Riker (1964).
[6]For further details, see Montinola, Qian, and Weingast (1995) and Weingast (1995).

A federation that satisfies all five conditions is called *market-preserving federalism*. In combination these conditions help foster and preserve markets by creating the appropriate incentives for effective economic policy.

Conditions F2 through F5 limit national power to two principal tasks: providing goods and services where the national government has a true comparative advantage (such as national public goods, including defense and a stable macroeconomic regime); and policing subgovernmental encroachment on the federal commons, such as the common market. Market-preserving federal systems delegate considerable authority to regulate markets to the subnational governments (F2). Because lower governments must compete for factors of production and tax revenue, they face economic limits on the exercise of discretionary authority. Jurisdictions that fail to foster markets risk losing capital and labor and hence valuable tax revenue.

F3 creates the conditions for the absence of trade barriers. Without F3, each subnational government would become a *de facto* "national government" in its jurisdiction, short-circuiting federalism's limits on lower governments.

A hard budget constraint (F4) concerns fiscal transfers among levels of governments and government borrowing (see Inman 2001, McKinnon 1997, Rodden 2000, Sanguinetti 1994, and Wildasin 1997). In systems with hard budget constraints, each level of government is responsible for matching revenues with expenditures and managing its own debt. The hard budget constraint can fail in a number of ways. In the first form, subnational governments have access to forgivable loans from the central bank in an uncoordinated fashion. This means that these lower levels of government do not internalize all of the costs of borrowing on the nation as a whole. Decentralized access to credit therefore softens the budget constraint. A second violation of the hard budget constraint arises

when lower jurisdictions expect higher governments to bail them out of deficit problems. When this occurs, lower jurisdictions face far less fiscal discipline. In the third form of violation, subnational governments can create their own currency. This softens their budget constraint to the extent that they can create more currency rather than raise taxes to finance their expenses (McKinnon 1997).

Condition F5 provides for credible commitment to the federal system. This condition requires that, beyond simple decentralization, the federal structure must not be under the discretionary control of the national government. This, when combined with F2, creates the conditions under which a federation is *self-enforcing*. In other words, it guarantees that the national government at once has the power to prevent violations of the federal bargain by the sub-units, but at the same time will not use its power to encroach on the subnational governments arbitrarily.

Market-preserving federal systems thus satisfy the classical economic principles of fiscal federalism. In accord with the assignment principle, condition F2 ensures that subnational governments have the authority to adjust their policies to their local environment. This condition also satisfies the Hayek principle. The common market and hard budget constraint conditions imply that subnational governments face Tiebout-like competition with other jurisdictions.

Collectively, as argued elsewhere, these principles create the conditions for the adoption of growth-enhancing policies. As shown in Figure 1, and argued in the previous literature, this occurs through the incentives created for a number of areas of national political economy. By encouraging the optimal sharing of authority outlined in the public finance literature on fiscal federalism (e.g. Oates 1972), providing the incentives to create markets, and limiting the incentives for rent-seeking behavior at all levels of government, market-preserving federalism, *ceteris paribus,* will lead to lower inflation, less corruption, promotion of industrial competitiveness, implementation of public

goods programs at all levels, greater commitment to policy, and its attendant benefits such as a stronger investment environment, and a tailoring of policy to local tastes. These benefits to *market-preserving federalism*, therefore, ultimately help nations that adopt these principles encourage growth-enhancing and socially beneficial public policies.

3. Comparative Economics of Federalism: The Pathologies of Federalism

Thus far, the discussion has focused on an ideal type of federalism that satisfies all five conditions and which is thus consistent with the classic principles of fiscal federalism. In this section, we show how conditions F2 through F5 provide a comparative theory of federalism. The economic and political performance of federal systems varies systematically with the combinations of the conditions they satisfy. Thus, here we go beyond the ideal type outlined in the previous literature to discuss the implications of failures to satisfy *subsets* of the principles in terms of the effects on a number of intermediate political economic variables that have implications for growth. This allows us to characterize three different forms of federal breakdown, as shown in Table 1, each a unique *pathology* of inappropriately designed federations.

The Pathology of Internal Trade Barriers

Consider a federation that satisfies all conditions but the common market axiom (F3). The absence of a common market produces a pathology of federalism associated with a common pool problem in which lower jurisdictions erect trade barriers to firms, products, and labor from other

areas.[7] By protecting local governments from competition with one another, trade barriers inhibit the political and economic benefits generated by that competition, as observed by Hayek (1939) and Tiebout (1956). Protection from outside competition also allows local jurisdictions to pursue the standard strategies of political intervention, such as creating local monopolies, corruption, and other forms of rent seeking.

The absence of a common market is likely to produce a federation with seemingly contradictory results. Some regions are likely to promote free markets within their borders, particularly those with easy access to international trade. Other regions with fewer market opportunities, however, are likely to exploit the absence of political competition for political gain through highly interventionist policies.[8] China since the mid-1980s provides an example.

The variance in the market orientation of local jurisdictions also implies far less pressure against political corruption and rent seeking. In particular, the higher a jurisdiction's trade barriers, the higher the likely corruption and rent seeking.

The failure to establish a common market also impinges on policy innovation at the state level. To see this, consider federalism emerging in a centralized country previously characterized by interventionist policies but where condition F3 fails. Then we expect the variance in performance

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[7]This is a common pool problem in the sense that the common market is a public good: each lower government has an incentive to erect protectionist barriers while allowing export of its goods elsewhere. But if all lower governments behave this way, there is no common market. Sustaining the common market thus requires that the center policing lower governments. For example, the common market in the early 19th-century United States could not have been sustained without the ever-vigilant policing of the Supreme Court. Policing the market against encroachments by state governments proved a major use of its constitutional powers. These cases reveal the remarkable diversity and cleverness of the states in their efforts to erect such barriers (see Weingast 1993); similarly, such barriers are a major reason underlying the movement for economic and political union in Europe (see Garrett 1992).

[8]To some extent, the differential access of states and localities in Mexico has produced different results about their pro-market orientation (Diaz-Cayeros, Magaloni, and Weingast 2000), although this is not a function of internal trade barriers

across lower jurisdictions just noted to be more pronounced immediately following the inception of federalism. Thus, for an economy like China's with only limited experience with markets, economic performance across provinces in the late 1980s differed enormously. As it became clear that those provinces fostering markets have gotten rich, the variance among provinces has diminished as others have attempted to imitate those which have succeeded.[9] Nonetheless, many interior provinces remain “dukedom” economies insulated from the world, without markets, and highly corrupt.

A country with limited exposure to markets naturally generates suspicion of them. This suspicion combines with the political forces preserving the status quo to prevent many central governments from adopting market-oriented policies. In a federal system, however, the ability of local governments to launch pro-market policy experiments independent of the central government can have beneficial effects for other regions.[10] As market growth occurs in some areas, the incentives for other jurisdictions to pursue protectionism will diminish. The experience with markets will reveal new information about how it allows local governments to provide for the needs of citizens. Even in the presence of strong trade barriers, fiscal pressures will push insulated areas to substitute market mechanisms for those activities in which the market has been demonstrated elsewhere to be a superior provider of particular goods and services.

The Pathology of Fiscal and Monetary Irresponsibility

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[9]See Montinola, Qian and Weingast, “Federalism, Chinese Style,” n11 supra.

[10] Strumpf (forthcoming) has argued that policy experimentation leads to free-riding. The reason is that experimenting with new policies has an externality that is not internalized by the experimenter, so there is a need for very strong private incentives in order to get the ‘optimal learning’ and diffusion–some cases will exhibit under-experimentation. Perhaps China’s granting authority to Guangdong to reform “one step ahead” of the other provinces reflects this principle.

A second type of federal pathology satisfies all the conditions except F4, creating another form of common pool problem associated with the soft budget constraint (Sanguinetti 1994, Rodden 2000). These federations lack centralized control over the monetary system or fiscal system.

Because subnational governments that cannot meet their current expenditures have access to credit without a requirement for financial prudence, they have an incentive to live beyond their means; that is, to borrow to finance too many expenditures, including many of which would not be financed were it not for access to credit in this manner.

Several problems are likely to emerge when authority over public credit is decentralized; that is, when credit remains at least in part at the discretion of lower governments. The most obvious is inflation as each government "over-grazes the commons," causing too much growth in the money supply. Federations in which the subnational governments have independent access to credit have exhibited this problem: China in the late 1980s had a mild form of this problem; in Brazil during the late 1980s, a soft budget constraint led to hyperinflation. Similarly, in federations in which the federal government has ultimate responsibility for the budgets of independent states but no control over expenditures, systematic exploitation of these incentives have led to national macro-economic imbalances, typically generating hyperinflation. Argentina in the mid and late 1980s and Brazil in the late 1980s experienced these problems (Dillinger and Webb 1998; Iaryczower, Sanguinetti and Tommasi 1999).

In addition to inflation, a soft budget constraint allows subnational governments to finance various forms of private rent seeking and other unremunerative forms of market intervention. Again, in many of the Latin American democracies and in Russia, the soft budget constraint has led to

widespread corruption either through bribes to public officials, wasteful administration or the diversion of private enterprise to the benefit of politicians (Treisman 1998; Iaryczower, et. al. 1999).

The Pathology of Distrust in the Federal Bargain

A final type of federal pathology reflects a federation in which the center imposes its will on the lower governments. Various types of federal systems allow this behavior; for example, if the central government holds regulatory authority over the economy (violating F2); if it provides lower governments with their revenue (violating F4) so that it may use its financial strings to control subnational government policy; or if the federal system remains at the central government's discretion, allowing it the unilateral authority to alter or remove the authority of lower governments (violating F5).

Federations of this type compromise lower jurisdiction autonomy. In the best case, they will behave more like centralized nations than nations characterized by market-preserving federalism, compromising the potential benefits of decentralization. In the worst case, they will create even greater levels of rent-seeking, corruption and market-distortions than those that would obtain under centralization. These federations typically prevent lower governments from deviating from national policies, thus stifling the advantages of decentralized policymaking in a federation, including competition between the states and heterogenous policies tailored to specialized requirements. With respect to the economy, lower governments in these federal systems are administrative units of the central government, not autonomous or sovereign governments. If the national government does not want a market economy, it has the power to prevent lower governments from fostering markets.

Federalism in Mexico illustrates this point. Over the years since 1940, the central government has used its financial control to centralize power, limiting subnational government policy discretion (Careaga and Weingast 2000). In Riker's (1964) terms, the center has overawed the subnational governments. A critical aspect to this control was the central governments credible threat under the sixty year political dominance of the PRI (the Institutional Revolutionary Party) to cut off funds from subnational governments that deviated from the center's goals (see Diaz-Cayeros, Magaloni, and Weingast 2000).

A variant on this scenario reflects a different type of federal pathology in which cooperation between center and subnational governments breaks down. Breakdown may arise in federations where the central government attempts to control subnational government behavior but is not quite strong enough to do so. In this scenario, central and subnational governments may attempt to take advantage of each other. For example, the center might use its power over the subnational governments to extract resources and force them to adhere to a variety of rules restricting their policy freedom. If the center is not sufficiently powerful to impose its will on the subnational governments, they can resist the center's attempts to extract resources and restrict their freedom.

As we discuss elsewhere (de Figueiredo and Weingast 2000a,b), subnational governments have few tools with which to resist. One of their principal means is withholding tax revenue. If many subnational governments do this simultaneously, they will restrict the federal government's powers and make it less likely to overawe them. Of course, this also restrict's the center's ability to provide public goods. This type of federalism is pathological in that cooperation has broken down entirely.

Does federalism preserve markets?

An empirical literature emphasizes a series of problems associated with federalism, such as higher levels of corruption and macro-economic imbalances (Tan**, Prod'homme 1995, Treisman forthcoming). The theory sketched in this section suggests that federal systems differ far too widely in their economic effects to have a uniform effect on markets. Indeed, the discussion above implies that many federal systems are very poor at preserving markets.

Our approach further suggests that the analysis of federations must take a more nuanced approach to scoring the independent variable. The comparative theory of federal economic performance provides an approach that explains which types of federalism protect markets, notably, market-preserving federalism. As noted, federal systems that differ from this ideal in particular ways will have economies that differ from an ideal market society in predictable ways. In sum, students of federalism must not compare federal to non-federal systems without first characterizing the *variation* in federal systems or *differences among* federal systems and predicting performance based on those characteristics.

4. Explaining differential economic performance across federations

Having discussed the predictions of differential economic performance of various types of federations, we now turn to a discussion of federalism in practice.

Table 2 classifies a number of important federal systems on two dimensions: which, if any, of the basic principles of market-preserving federalism they exhibit; and their degree of economic

growth.[11] Federal states that have met all or nearly all of the five conditions — that is, those characterized by market-preserving federalism — have experienced sustained long-term growth. Federal states failing to meet these conditions have experienced meager or no growth.

Throughout its history, the United States has been a market-preserving federal system. Except for a brief period under the Articles of Confederation, the common market condition, F3, has always held, as has F4, the hard budget constraints for lower governments (the national government does not bailout states). Until the 1960s, states retained the lion's share of authority over economic regulation, and to this day they have authority over basic property rights and contract law. As argued elsewhere, the conditions have made a significant contribution to this country's economic prosperity and growth (Weingast 1995).

Similarly, England during the eighteenth century and hence the industrial revolution had a market-preserving federal structure, though not a de jure one. Constitutional changes following the Glorious Revolution of 1689 limited the national government's role in the economy and improved local government autonomy. This proved especially important during the Industrial Revolution, which took place not in the established commercial centers but in more remote northern England, in part, to escape a range of traditional and new economic restrictions hindering the new firms (Weingast 1995).

Many de jure federal systems differ considerably from market-preserving federalism. For example, in Argentina, Brazil, and Mexico, conditions F2 and F5 fail, and often F4. In most Latin American federations, the majority of state revenue comes from the national government. This creates several problems in these countries. First, it breaks the link between local economic

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[11] CASE SELECTION?

prosperity and fiscal health (Careaga and Weingast 2000). Second, and perhaps more importantly, the revenue transfers are accompanied by restrictions, rules, and regulations from the center. Until recently in Mexico, the dominant PRI party used its political power, to limit lower government autonomy. The President, as head of the PRI, used his authority to fire governors, thus limiting their ability to act independently (compromising F5). These Latin American federal systems all compromise lower government autonomy so that these governments have neither the incentive nor the ability to differentiate themselves from their neighbors. In addition, Argentina in the 1980s and Brazil in the 1990s both experienced hyper-inflation due in part to profligate behavior of the lower governments, which ultimately led the federal government to bail them out. The anticipation of such bailouts creates a soft budget constraint (i.e., the failure of F4) which led states to spend well beyond their means. More broadly, the failure of F2, F4, and F5 means that the political discretion and authority retained by the central government greatly compromise their market-preserving qualities.

The de jure (though not de facto) federalism of the former Soviet Union provides another contrast between market-preserving federalism and other types of federalism. In that system all five conditions failed, implying that it had no meaningful federalism. The Soviet Union was characterized by the nearly complete absence of subnational government policy discretion, and hence the failure of F1, F2, and F5. Lower governments were administrative units of the central government having little power over their local economies. The center also carefully controlled factor mobility. As a consequence, federalism provided no positive incentives toward economic growth. The absence of a hard budget constraint (F4) allowed the state to bailout ailing state owned enterprises, removing all incentives from these firms to produce efficiently. Finally, the Soviet Union suppressed markets and controlled capital and labor movements, so that the common market condition (F3) also failed.

Finally, consider modern China. Although it does not call itself federal, China has extensively decentralized political decision-making, particularly over lower government budgets and over the economy. China now satisfies all the conditions except F3, though there was a modest problem with soft-budget constraints leading to modest inflation in the 1980s and early 90s. The failure of F3 implies that many interior provinces have created trade barriers and "dukedom economies" characterized by market control and often corruption. In contrast, because many of the coastal provinces have sought to grow rich through competitive in international market, the lack of a domestic common market did not compromise their incentives to foster economic growth. These provinces' political autonomy over economic regulation allowed them to provide a remarkably hospitable environment for markets and hence sustained economic growth (Montinola, Qian, and Weingast 1995). Indeed, Guangdong's famous "one step ahead" allowed it to use its new political discretion over the economy to attract an unprecedented level of investment and economic growth.

5. Federalism, Russian Style

An appropriately structured federal system seems well suited for a country as large and diverse as Russia. The wide range of circumstances across eleven time zones and two continents implies significant gains from the political freedom to tailor policy to local conditions over a one-size-fits-all policy from Moscow. Reflecting on Russia's size and diversity, the OECD (2000,113) concludes that "a fiscal federalist system that delegates a larger share of responsibility to lower levels of government has become the only feasible option." Moreover, as Stoner-Weiss (1997,88) argues, democratization

has led to both decentralization and a dramatic increase in the "regional governments' sphere of activity."

Despite its promise, federalism in Russia exhibits a range of pathologies discussed above. Indeed, Russia violates both the classical federal principles articulated by Hayek, Musgrave, Oates, and Tiebout as well as those associated with market-preserving federalism.

Perhaps the most significant characteristic of federalism, Russian style, is the striking lack of cooperation between center and regions. Although Yeltsin once proclaimed that he would give the regions all the freedom they could stand, in reality, the center has tried to exert its control over the regional governments. This control includes attempts by the center to mandate expenditures, limit the regions' policy flexibility, and to constrain the regions' authority to tax. Regions also face a major imbalance between their expenditure responsibilities and their resources. Revenue sharing also appears to exhibit a ratchet effect, so that regions that increase their revenue are likely to see their transfers decline.

Yet the center has proved insufficiently strong to enforce its will, with the regions resisting the center's attempts at control. Following democratization, many regional governors have emerged as "local heroes," in part through resisting the federal government (Stoner-Weiss 1997). Perhaps the most critical aspect of this resistance is the informal system of budgeting and taxation. This system allows regions in part to skirt Moscow's rule, increasing transaction costs at the expense of transparency (OECD, 2000, 144; Shleifer and Treisman 2000). Many regions have resisted Moscow's attempt at economic reform; and many have devised clever strategies by which they divert tax revenue for their own uses instead of sending it to Moscow, exacerbating the center's financial problems.

This system also produced in the mid-1990s an "asymmetric" federalism in which those regions with the greatest ability to make trouble for Moscow received the best fiscal deals (Solnick 1995, Treisman 1999). In the short-run, this pattern of bargaining kept the federation together. In the long-run, it exacerbated non-cooperation. As Shleifer (1997,403-04) concludes, "the regions that get the most revenue are the ones that create trouble for Moscow: they have strikes, labor unrest, and separatist movements... *[P]eace and prosperity in a region do not, evidently, increase the resources of the local government...*" [emphasis added].[12]

Evaluation of Federalism, Russian Style

We now use the conditions above to evaluate the structure and incentives of Russian federalism. Three scholars evaluate Russian federalism against this benchmark and conclude that Russia fails nearly all the conditions (see Slider 1997, Treisman 1999,20, and OECD 2000,115). According to the OECD (2000,115), "the case of Russian Federation involves the gross violation of virtually all of these conditions, while economic policies have a reported anti-reformist orientation in many regions." Reflecting the pathological nature of Russian federalism, Slider (1997) calls Russia's system "market-distorting federalism."

1. Conditions F1 and F2. To begin, consider conditions F1 and F2. Russia's assignment of policy and tax authority is a tangled mess (OECD 2000,**). Contradicting the standard economic principles of federalism associated with Hayek (local information expertise), Musgrave and Oates

[12] Shleifer and Treisman (2000, 110) echo this observation: "The years 1992 to 1994 saw an increase in [Russian] federal budget transfers to regional governments (from 1.7 to 3.8 percent of GDP) and a decentralization of tax revenues (from 54 percent federal to 47 percent federal as the center reluctantly accepted lower payments from the most separatist republics. In essence, the federal government appeased regions that threatened political or economic stability–by declaring sovereignty, staging strikes, or voting for the opposition in elections–by allocating them larger transfers or tolerating their tax withholding."

(assigning authority over local public goods to the unit best able to provide them), the federal government attempts to control far too much of subnational government policymaking authority. Moreover, in many cases, it is not clear which government has authority over particular taxes; and all levels of government to a degree ignore the official tax assignments. Using the standard economic principles, Wallich (1994) concludes that the Russian assignment of policy authority is confusing, uncertain, and irrational. Despite recent attempts to rationalize authority in the last few years, these conclusions remain true today (OECD 2000,130).

The Russian Constitution grants many exclusive powers to the federal government (Article 71). The Constitution designates most of the remaining powers as shared (Article 72). In combination, these articles leave little within the exclusive purview of the subnational governments. Further, the constitution allows the president to suspend local laws for various reasons.

The center also mandates the vast majority of both tax and spending decisions (Lavrov, Litwack, and Sutherland, 2000,6). At Russia's inception, much of the initial assignment of subnational government expenditure was driven by the center's financial distress rather than a logical assignment of authority based on administrative comparative advantage. For example, many local expenditures "took the form of a simple refusal by the federal government to finance certain expenditure categories," leaving subnational governments to pick up these expenditures, typically without any explicit source of finance (OECD 2000,129). Virtually all social expenditures have been devolved to regions and local governments. This dramatically limited the redistributive component of these expenditures. Moreover, in many of the policy areas covered by the confusing joint responsibility, it remains unclear which level of government bears financial responsibility.

Subnational governments thus face a wide range of unfunded mandates. Although officially eliminated in 1993 and transformed by presidential decree to a status of "recommended," a great many of these mandates persist. Some courts, for example, have interpreted these expenditures as mandatory, forcing regions to finance them (OECD 200,131). An OECD (2000,131) survey estimates that, if regional governments meeting all mandated expenditures would consume 60 percent of regional consolidated revenues. This figure understates the extent of these mandates, since the federal government controls the majority of subnational expenditures through various norms and regulation that leave very little flexibility for decentralized allocation. The result is that "subnational budgets have exhibited a chronic imbalance between expenditure obligations and financial resources" (OECD 2000,136).

Next, consider taxation. According to the OECD (2000,126), roughly 80 percent of all regional and local budgetary revenue comes from sources under control of higher levels of government (see also Shleifer 1997). In contrast, only 8 percent of revenue derives from sources under the discretion of regional and local governments (as even these are regulated by the center).

A second problem with taxation is perhaps even worse, namely, that subnational government revenue appears subject to the ratchet effect. Studying the relationship of cities to their regions, Zhuravskaya (1999) calculates that, for every additional ruble raised by a local government, the regional government reduces its subsidy by 90 kopecks.[13] Shleifer and Treisman (2000,122) conclude

[13] Shleifer and Treisman (2000, 122) indicate that similar problems occur between regional and national governments. "From 1994, transfers to support 'needy' and 'especially needy' regions have been allocated from the federal budget out of a Fund for Financial Support of the Regions (FFRS), ostensibly under a predefined formula. This formula allocates higher transfers to regions with lower revenues and higher budget deficits in the 'base' year. The base year has continually moved forward, however, and has usually been just one to three years prior to the year in question. As a result, regional governors know that any improvements in tax collection in their regions or reduction in their budget deficits quickly lead to lower allocations of transfers from the FFSR."

that, "[b]oth regional and local governments have had their fiscal benefits reduced by higher levels when they have succeeded in increasing the effectiveness of tax collection. They have been victims of the infamous 'ratchet principle.'" Blanchard and Shleifer (2000) suggest that the figure is slightly lower for federal government appropriation of additional revenue raised by the regions than that found by Zhuravskaya for cities. The OECD (2000,133-36) reports that the instability of regulations and controls "reinforces the perception that improving budgetary performance today will only ratchet up the pressure for better performance in the future, leaving insufficient rewards at the regional or, especially, local level." To the extent that the ratchet effect holds in Russia, it creates a major pathology by removing the fiscal incentives for subnational governments to foster local economic prosperity.

Shleifer (1997,403-04) compares the Russian fiscal system with that in Poland. In Poland, local governments' principal source of tax revenue are fees and local taxes, particularly the property tax. This provides local governments with the incentive to foster local economic prosperity so as to raise their tax base. In contrast, in Russia, such a large portion of revenue derives from the central government that "Governors have little incentive to broaden their tax bases."

Another problem reflects the center's inability to enforce its rules, which has allowed an informal system of autonomy by which subnational governments skirt the rules. This autonomy does not arise through a logical design that assigns particular policies to the most appropriate level of governmental. Instead, autonomy arises because a region can make trouble for Moscow or because the subnational government can effectively hide revenue and expenditures from the center. This system is highly inefficient and typically involves high transactions costs. For example, lower governments frequently arrange for profitable enterprises to provide local goods and service, such

as housing, roads, schools, stores, and so on, often in exchange for some form of local privilege. A principal advantage to both enterprise and subnational government from these bilateral arrangements is that they save on the federal taxes. In parallel, subnational governments have incentives to increase the informal sector of the economy and nonmonetary arrangements, such as barter, since it is easier for them to cement such deals with transactions that are more difficult for the center to monitor (Shleifer and Treisman, 2000, Chapter 5).

Subnational governments thus fail a major principle of the rule of law: they do not establish a uniform tax system specified in advance that applies to all enterprises. These governments instead typically negotiate taxes bilaterally with each enterprise. This system allows them to "price discriminate" among enterprises. In contrast to a system of uniform taxation that treats all enterprises alike, the bilateral negotiation system allows subnational governments to extract part or all of the value of new enterprises. This system has several negative economic consequences. First, because bilateral negotiations are necessarily secret, they increase opportunities for corruption. Second, as Shleifer and Vishney (1993) suggest, the secrecy necessary for corruption results in more distortion than simple taxation. Last and most importantly, discriminatory taxation discourages new investment and local economic prosperity. Under a uniform system of taxation, those enterprises with the highest social surplus are most likely to be undertaken, as they yield the highest profitable returns. This condition clearly fails to hold under a discriminatory tax system that allows the government to extract the surplus value.

Combining these observations yields several conclusions. First, formal subnational autonomy in Russia is "considerably lower than in most federations, especially in developed federations such as Canada, Switzerland, and the United States, where subnational governments have almost complete

autonomy in choosing tax bases, types and rates" (Lavrov, Litwack, and Sutherland 2000,7). The ubiquitous federal controls also provide subnational governments with an incentive to absolve themselves of responsible fiscal and policy behavior. Second, the assignment of expenditure and taxation authority contradicts all major principles of fiscal federalism and market-preserving federalism, considerably hindering improving the social surplus. Third, the conflicts between center and region hinder cooperation, further reducing social welfare.

In combination, these conclusions also imply that subnational government have little incentive to improve their economic situation. Higher government appropriation of greater revenue implies that hard efforts to improve local economy go unrewarded; to the extent that these expenditures are locally costly, they will not be undertaken, even if they improve welfare.

2. Condition F3. Russia also has considerable encumbrances on the common market (F3). The Constitution grants the federal government the authority to enforce a common market (Slider 1997,498). Since the fall of Communism, interregional markets in many urban consumer goods have expanded. Yet informal subnational government discretion has allowed them to provide a degree of protection for local firms (OECD,2000,**, Slider 1997,498-99). Although this protectionism reduces total social welfare, it increases local firm revenue and local tax revenue, and it helps maintain local jobs. Regional leaders have also prevented export of many goods, particularly foodstuffs, to neighboring areas (Slider 1997,499).

This implies the emergence of some trade barriers, and thus some limits on product competition across jurisdictions. This is further exacerbated by a poor transportation system that hinders interregional trade.[14]

[14] Notably, this in itself can be seen as a failure to provide an important public good.

Interregional trade and factor mobility are also encumbered by the limited ability of firms to make long-term contracts without extraction by local governments. Similarly all levels of government lack the ability to commit credibly to honoring deals with firms for investment. The risk of ex post expropriation is a major hindrance on new investment, especially investment across jurisdictional lines. These distortionary incentives combine with problems inherited from the Soviet era, such as a pattern of firm location following the (il)logic of socialist planning and an antiquated transportation system. In combination, these factors imply significant encumbrances on capital mobility and hence the exploitation of gains from exchange across jurisdictions.

Finally, a range of institutions inherited from the former Soviet Union but still in operation hinder labor mobility. For example, because housing benefits are often tied to jobs, workers find it very difficult to quit a job and move to a new area. This implies de facto limits on labor mobility.

In sum, F3 remains significantly incomplete because of incomplete factor mobility and product competition across jurisdictions.

3. Condition F4. The Russian Federation also performs poorly with respect to a hard budget constraint. Officially, transfers from the federal to regional governments are relatively small, approximately 15 percent of regional revenue. In practice, however, this understates their effect. A big debate has raged about the rationales underlying federal transfers (see, e.g., Solnick 1995,1997, and Treisman 1999), and many factors matter. Yet transfers do appear to respond to current budgetary needs, implying a degree of soft budget constraint (Lavrov, Litwack, and Sutherland 2000,9; Slider 1997,500; Shleifer and Treisman 2000).

One of the most interesting aspects of the Russian economy is the emergence of money surrogates (Shleifer and Treisman 2000, 97-98 and 125-128, and Woodruff 1999a,b; see also Lavrov,

Litwack, and Sutherland, 2000 and OECD 2000, ch 2). Often these emerge for fiscal reasons, as a means of hiding activities from the central government. From the standpoint of the soft budget constraint, the emergence of *veksels* or local bills of exchange is an important aspect of money surrogates. These are a type of local currency that softens a regions budget constraint by allowing it to issue bills of exchange instead of raising taxes to finance its expenditures. The OECD (2000, ch 2) estimates that *veksels* represent a critical part of finance for many regions. The ability for regions to create money surrogates shows that the Russian central government fails along one of the principal dimensions of a modern government, exclusive control over the monetary system.

Similarly, an explosion of subnational government debt occurred in the mid-1990s, allowing them to issue debt for current expenses. These observations suggest a soft budget constraint weakening financial pressures for responsible government and policy choice.

In combination, these practices imply that the regions have no financial incentives to promote local economic prosperity. Indeed, because it reduces the fiscal penalties associated with these policies, the soft budget constraint encourages rent-seeking, corruption, and costly market intervention.

4. Condition F5. Finally, Russia also measures poorly with respect to condition F5, the degree of institutionalization of federalism. The federal government retains too much discretion over the structure of federalism. Further, too much fluctuation in the rules implies instability, making long term planning by subnational governments and enterprises difficult. As suggested in the analysis above, this uncertainty and unpredictability affects government and firm incentives. The central government has regularly altered the rules. In general, the lack of institutional security to the rules also implies that a determined leader less focused than Yeltsin on economic reform could easily

increase the degree of centralization. The recent reforms by Putin attempting to recentralize power – through the creation of "super-regions" and changing the composition of the Federal Council – are a prime example of a recent arbitrary recentralization effort. In the end, the failure of rules to create self-enforcing limits on *both* central aggrandizement and state shirking have led to a situation in which the states do not comply with central edicts and the national government becomes increasingly extractive: a degenerate, non-cooperative federation (for a more detailed discussion of these issues see Blanchard and Shleifer 2000; de Figueiredo and Weingast 2001a,b).

A brief comparison with Federalism, Chinese Style

Many students of the Russian transition argue against drawing lessons for Russia from China's experience with transition (e.g., Anders 1994, Sachs and Woo 1994). These scholars emphasize the differences in the types of transition, such as China's lack of financial distress or its far more traditional agrarian economy, in contrast to Russia's industrial one. Although we agree that many differences distinguish Russia's transition from China's, we disagree with the conclusion that no lessons can be drawn from the comparison.

A straightforward comparison of the structure of Russian and Chinese federalism shows that China's system, although not first best, generally conforms to the set of principles noted above, both classical economic and market-preserving federal ones; whereas Russian federalism violates them all. Given that successful transition to market economy requires creating the appropriate incentives for governments of all levels to foster rather than control markets, these institutional differences seem critical to the differential success of the two transitions. For example, China's fiscal policy system provides high-powered fiscal incentives for subnational governments to foster local economic

prosperity (Oksenberg and Tong 1992, Oi 1992, Montonola, Qian, and Weingast 1995, and Shirk 1993).

In contrast to Russia, China has allowed subnational governments a striking degree of policy responsibility for regulating the economy, along with adequate means of finance. Unlike Russia, Chinese provinces were free to retain their historic socialist system, and many did so. Some of this subnational policy authority is informal, as in Russia. But it is also clear that the central government generally approves this, whereas in Russia, it attempts to prevent this type of autonomy. Moreover, the Chinese center has not fostered hostility with the provinces by attempting to force them to conform to its reforms. The Chinese central government has allowed provinces to experiment with reform rather than forcing them to do so.

The Chinese central government has also actively fostered decentralization and local policy authority. We have already mentioned the fiscal contracting system. As another example, the central government granted Guangdong the policy authority to reform "one step ahead." Guangdong's economic success created a demonstration effect that was greatly admired and envied. Many other provinces then sought to imitate Guangdong's success (Montinola, Qian and Weingast 1995).

Provinces also faced the appropriate fiscal incentives. A hard budget constraint forces subnational governments to internalize the financial consequences of their policymaking. As an example, many subnational governments were forced to allow several million new local enterprises to go out of business during the downturn in 1989 following the Tiananmen square. Again in contrast to Russia, fiscal incentives have also forced many subnational governments to reform their ailing state owned enterprises (Cao, Qian, and Weingast, 1999). On the positive side, those provinces and lower governments that succeeded in fostering local economic prosperity themselves became

prosperous. Jin, Qian, and Weingast (2001) calculate that, for the high-growth reform period of 1982-1992, provinces retained at the margin 89 percent of any additional revenue. These arrangements allowed successful provinces to retain huge fiscal surpluses, in contrast to Russia's extraction of most fiscal success.

The most striking difference between China's success and Russia's failure is that the Chinese government succeeded in aligning government incentives with fostering markets, whereas Russian institutions have exactly the opposite effect. China designed a sound system of fiscal federalism with appropriate incentives for lower governments. China's economic success thus rests on conforming to a range of principles about the design of federalism so as to foster markets. Despite the reluctance of Russian specialists to acknowledge the relevance of the Chinese experience, the behavior of the center differs in part because of Russia's poor political design.

6. Conclusions

Economists emphasize that a successful economic transition from socialism requires that the new system provide economic actors with appropriate incentives; that is, the new economies must "get prices right." In this paper, we emphasize the parallel point about the economic role of the political transition from socialism: successful economic transition requires that the new system provide political officials with the appropriate incentives to foster economic prosperity. In particular, officials must have incentives to pursue policies that "get prices right" instead of those that foster corruption,

rent-seeking and market distorting intervention. Until recently, too little attention has been given to the incentive compatibility requirement for political officials.

We investigate these general issues in the context of federalism, developing a theory of differential federal economic performance. The theory shows how different forms of federal institutions provide different incentives for subnational government behavior, with predictable consequences for economic growth and prosperity. We also discuss an ideal type of federation, called market-preserving federalism, that conforms to the classical economic principles of federal design associated with Hayek, Musgrave, Oates, and Tiebout. This ideal federalism provides subnational governments with the incentive to foster local economic prosperity while penalizing corruption, rent-seeking, and distorting economic intervention.

Our approach also identifies a range of federal pathologies; that is, federal systems that, in some systematic way, fail to provides subnational government officials with incentives to foster local economic prosperity. Federal pathologies occur as various conditions of market-preserving federalism fail to hold.

Perhaps the most important contribution of this effort is to address a long-overlooked problem in the theoretical and empirical literatures on the relationship between federalism and economic performance. In particular, this paper provides a first step towards distinguishing between *forms* of federalism. Indeed, as we argue, while some federal institutions help foster and preserve markets, this will occur only if the institutions are properly designed (Garman, Haggard, and Willis 2001 and Ordeshook 1996). In the absence of such appropriate institutions, federalism can actually enhance market distortions, corruption and rent-seeking. This, then, implies that the appropriate comparison is not between centralized and decentralized forms, but that there are multiple types of

federations, some which, all things equal, should perform better than central systems, and others which will perform worse. Indeed, this might explain in part the mixed empirical results on the impact of federalism.

The range of economic outcomes in various federal states are consistent with our approach. High growth federal systems – such as the modern United States or China – roughly correspond to the ideal. In contrast, low or no growth federal systems correspond to various pathologies, including Argentina, Brazil, India, Mexico, and Russia.

We applied our approach to federalism, Russian style. Federalism in Russia exhibits a range of pathologies identified by the theory. In several respects, Russia's federal structure fails to give subnational government officials the incentive to foster local economic prosperity. First, subnational governments have too little policymaking authority with which to tailor local policies to local conditions. Second, significant welfare losses arise because the informal policy authority they have wrestled from the center does not conform to classical assignment principles. Third, aspects of the soft budget constraint increase opportunities for subnational government corruption, rent-seeking, and market intervention. Finally, the form of informal autonomy allows subnational governments to extract too much rent from profitable enterprises. Because subnational governments can extract more rents from more profitable enterprises, the Russian political system markedly decreases the economic incentives for new investment. In striking contrast to the Chinese system, the structure of Russia's fiscal federalism provides few fiscal incentives for subnational governments to foster local economic prosperity.

Federalism, Russia style, fails to conform to either the classical economic principles of federalism or those associated with market-preserving federalism. The assignment of policies to

different levels of government has been based on political expediency rather than on a logical design conforming to standard principles. As Wallich (1994) observed, Russia's assignment of taxation and policymaking authority makes no economic sense. The center's wide-ranging attempts to control regional government behavior forces a "one-size-fits-all" set of policies on a diverse economy with dramatically different needs. These attempts violate the three classic principles of fiscal federalism. First, central control fails to allow local jurisdictions the political freedom to adjust policy to fit local conditions. Hayek (1939) observed long ago that central control can never know enough to adjust policies to local circumstances. Second, it violates the assignment principle, granting policy authority to the appropriate level of government. Finally, these controls prevent the mechanism emphasized by Tiebout (1956) of allowing both policy flexibility to reflect local demand conditions and hence the political competition among local jurisdictions that is important for their behavior.

The center's attempts to force conformity among subnational governments produce another bad feature of federalism, Russian style. In combine with acts of political opportunism, the center's attempts to control the regions generate significant mistrust. In reaction, the regions resist the center – they hide their activities, including their revenue. Further, they resist Moscow's policies, often including those designed to improve national welfare. The lack of cooperation not only generates a series of costs, but it hinders center and region from solving a range problems.

Russia's center also fails some of the minimally necessary political aspects for economic growth. Russia fails to provide a stable political set of rules on which all can depend. Rules that are subject to ex post adjustment allow a degree of opportunism. The system of tax competitive among levels of government implies that taxes are too big a burden (Litwack 2000, Shleifer and Treisman 2000, **). This hinders both private and public investment. Further, the center's apparent extractive

tendencies exacerbate mistrust and fear by the regions. Worse, this behavior penalizes economic success, dramatically reducing the fiscal incentives of lower governments to promote local economic prosperity. The center also fails to provide a range of basic public goods of western democracies, such as various categories of social expenditures. Forcing these down to the regions greatly hinders any equity component.

Regions thus have poor fiscal incentives to promote prosperity, and the soft budget constraint implies only weak fiscal penalties for costly economic intervention and rent-seeking. Constraints on factor and product mobility hinder the competitive process among lower jurisdictions, thus weakening this source of incentives for good performance by local governments.

In short, we judge federalism, Russian style, pathological because it lacks a consistent, credible, and financially sensible lines of authority between center and regions. The result is a misallocation of energy and effort, and a substantial impediment to Russia's transition to a market economy. The substantial degree of mistrust and non-cooperation represents a major impediment to Russia's attempts to improve social surplus. The problems identified in this paper are not just one of many problems hindering Russia's transition. They are emblematic of Russia's systematic failure to create a political system consistent with promoting economic prosperity.

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