IMF Staff Papers
Vol. 48, Special Issue
© 2001 International Monetary Fund

Federalism With and Without Political Centralization: China Versus Russia

OLIVIER BLANCHARD AND ANDREI SHLEIFER*

In China, local governments have actively contributed to the growth of new firms. In Russia, local governments have typically stood in the way, be it through taxation, regulation, or corruption. We argue that the difference can be traced to lies in the degree of political centralization present in China, but not in Russia. In China the central government has been strong and disciplined enough to induce local governments to favor growth. In Russia, it has not. We agree, but with an important caveat. We believe the experience of Russia indicates that another ingredient is crucial, namely political centralization. [JEL P30, P50]

Over the past decade, China's GDP has grown at one of the highest rates in the world, Russia's at one of the lowest. The difference has come mostly from the growth of the new private sector. In China, the new private sector has thrived. In Russia, it has stagnated.

Why this sharp divergence between private sector evolutions? In both countries, the evidence points to the importance of the behavior of local governments. In China, local governments have actively contributed to the growth of new firms (Oi, 1992; Qian and Weingast, 1997). In Russia, local governments have typically stood in the way, be it through taxation, regulation, or corruption (Shleifer, 1997; Johnson, Kaufmann, and Shleifer, 1997; McKinsey, 1999; and EBRD, 1999).[1]

*Olivier Blanchard is Professor of Economics at the Massachusetts Institute of Technology. Andrei Shleifer is Professor of Economics at Harvard University. They thank Stanley Fischer, Alan Gelb, Ed Glaeser, Simon Johnson, Ratna Sahay, Jim Snyder, and Daniel Treisman for comments. They thank the National Science Foundation for financial assistance.

[1]The McKinsey study of 10 sectors of the Russian economy, and of the specific obstacles faced by new firms in each sector, is particularly instructive in this regard.

There are two main hypotheses for the attitudes of local governments in Russia. The first—call it "capture"—is that local governments have been captured by the initial rent holders, primarily by the old firms that dominated the Russian economy before the transition. In this view, local governments have worked both to generate transfers to these firms, and to protect them from competition by new firms. In this first view, their hostile attitude vis-à-vis the new private sector has been deliberate. The second view—call it "competition for rents"—is that the behavior of local governments has been instead the unintended result of administrative disorganization. Too many agencies have tried to extract rents from new private firms, making it unprofitable to create or run a private business, at least legally.[2]

These two lines of explanation are plausible and not mutually exclusive, but they raise the obvious question of why things have been different in China. Here again, there are two main hypotheses.

The first is that the initial rent holders were weaker in China than in Russia. China started its transition from a very low level of economic development. Its agriculture did not rely on large collective farms, and its industry had relatively few large enterprises. Russia, in contrast, started its transition as a fully industrialized economy, dominated by large state firms and collective farms. According to this view, the potential for capture was simply more limited in China than in Russia.

The second view points to the strength of the central government in China. Transition in China has taken place under the tight control of the Communist party. As a result, the central government has been in a strong position to either reward or punish local administrations, reducing both the risk of local capture and the scope of competition for rents (Huang, 1998). By contrast, transition in Russia has come with the emergence of a fledgling democracy. The central government has been neither strong enough to impose its views, nor strong enough to set clear rules about the sharing of the proceeds of growth (Shleifer and Treisman, 1999; Treisman, 1999b). As a result, local governments have had few incentives either to resist capture or to rein in competition for rents.

The aim of this paper is to explore this last argument, and more generally to explore the role of federalism in transition. The question is an important one. Based on the experience of China, a number of researchers have argued that federalism could play a central role in development (see in particular Qian and Weingast, 1997; Roland, 2000). Indeed, a new term, "market preserving federalism," has been coined to emphasize the benefits of decentralization for Chinese growth. We agree, but with an important caveat. We believe the experience of Russia indicates that another ingredient is crucial, namely political centralization. In doing so, we echo a theme first developed by Riker (1964): for federalism to function and to endure, it must come with political centralization.

[2]Shleifer and Vishny (1993) have shown how such disorganization and competition for rents leads to a much worse outcome than monopoly corruption from an organized government. Based on a survey of shops in Russia and Poland, Frye and Shleifer (1997) have shown shops in Moscow are visited by a much larger number of inspectors and regulators than shops in Warsaw.

I. A Model of Federalism and Incentives

We start by writing down a model of federalism and local government incentives. The model is very simple, but it provides a convenient way to look at the facts and discuss the issues. This is what we do in the next two sections.

Think of the government as having two levels: central and local (in other words, ignore for the moment the fact that there are at least three relevant levels of government in both Russia and China: central, regional, and local).

Suppose each *local government* faces a simple choice. It can either foster growth, by limiting transfers of resources to state and former state firms and allowing new private firms to enter and to grow. Or it can kill growth, by transferring resources to old firms and/or preventing new firms from being created.

Why might a local government choose the second option? Under the "capture" view, it may want to protect state or ex-state firms from competition. Under the "competition for rents" view, it may be simply unable to prevent bribes and corruption by local officials. Sorting out the relative importance of the two should be high on the research agenda but is not essential here. For our purposes, both have the same implication: no growth.

Let y be the additional output under growth. With appropriate normalization, let y also stand for the additional amount of revenues available to the central and local governments under growth. Let b be the private benefits to the local government of killing growth. Under the capture interpretation, b may reflect the transfers back from existing firms to the local government, in the form of bribes, cash, or in-kind payments. Under the competition for rents interpretation, b may reflect the cost to a local government of reducing or coordinating bribe taking by local officials.

Now turn to the *central government*. Assume (an assumption to which we return later) that the central government wants to foster growth, and think of the central government as having two main tools, a carrot and a stick:

- Revenue sharing (the carrot): The central government can choose the extent of revenue sharing with local governments. Let a be the share of revenues from additional growth going to local governments: if a local government chooses to foster growth, it gets ay in revenues.
- Political centralization (the stick): The central government can affect the probability that the local government stays in power to enjoy either the revenues from growth or the private benefits from killing growth. Denote by p_x the probability that the local government stays in power if it kills growth, and by p_y the corresponding probability if it fosters growth. Define $p = p_y/p_x$. The value of p clearly depends first on whether local officials are appointed or elected. If they are appointed, then presumably the central government can choose p freely and make it as high as it wants. If they are elected, the outcome depends on the ability of the central government to affect the outcome of the election, through endorsement and support of specific candidates. If the center has little control over the outcome, and capture is important, p may be less than one: the local government may be more likely to stay

in power if it kills growth than if it fosters it. All it may take is for incumbent firms to be better organized politically than new entrepreneurs.

Under these assumptions, the local government chooses growth if $p_y\, a\, y > p_x\, b$, or equivalently if

$$p\, a\, y > b. \qquad (1)$$

The local government is more likely to choose growth, the stronger the stick (the higher p), the bigger the carrot (the higher a), the larger the growth potential (the higher y), and the smaller the benefits of capture or the lower the costs of reining in competition for rents (the lower b). This formula provides a convenient way of organizing the discussion of Russia versus China.

II. Growth, Tax Sharing, Political Centralization, and Other Issues

Before proceeding to look at the empirical evidence on the various parameters of the model, one may well want to challenge the assumption that the central government is pro-growth, or at least more pro-growth than local governments. Surely, both China and Russia provide numerous examples where the policies of the central government destroyed the economy. In the context of transition and change, however, the assumption that the central government is less likely to be captured by initial rent holders than local governments seems reasonable. Local governments are smaller relative to state and ex-state firms, more directly affected by the unemployment implications of closing a particular firm, and more likely to respond favorably to requests for transfers or protection. Central governments may be captured, as well, but not necessarily by groups opposed to growth. Capture by the "oligarchs," for example, may well lead to a massive redistribution of wealth in their favor but not necessarily to lower growth.[3]

Much previous research has focused on y. If growth prospects are very good, then letting new firms enter and fostering growth is attractive. The example of Moscow, and of its mayor, Luzhkov, comes to mind here. But if growth prospects are dim anyway, the returns to allowing new business to enter and grow as opposed to protecting the old firms may be low, and y may be small.[4] This is particularly likely if the improvements from pro-growth policies take a long time to materialize, and the incumbent politicians are unlikely to benefit from them.

If y is small, there may be little the center can do to convince local governments to choose growth. Even large values of a and p may not change the inequality.

A number of recent studies have provided some evidence on a, both for Russia and for China. In an econometric study of the fiscal relations between China's

[3]For more discussion, and a more agnostic view, of whether central or local governments are more likely to be captured, see the discussion in Bardhan and Mookherjee (2000).

[4]Our normalization that government revenues move with output may not be innocuous here: y, interpreted as government revenues, may be low not because additional output is low, but because the government—local or central—cannot successfully tax incremental output, which is hidden in the unofficial economy or through transfer pricing.

regional and central governments, Jin, Qian, and Weingast (1999) have found a high value of marginal a, about 0.8. (In describing the evidence, we need to distinguish between the three levels of government: central, regional, and local.) No corresponding study exists for the relations between China's local and regional governments. Wong (1997) suggests that the nature of the contracts between local and regional governments, and therefore the outcomes, may be similar to those for the relation between central and regional governments.

In an econometric study of the fiscal relations between Russia's local and regional governments, Zhuravskaya (2000) has found that marginal a is only about 0.1, giving local governments only weak incentives to increase the tax base. No corresponding study exists for the relations between Russia's regional and central government. In personal correspondence, however, Treisman has reported that estimates of a obtained from regressions with a specification similar to that of Jin, Qian, and Weingast (1999) are not lower for Russia than they are for China.

In sum, the evidence is somewhat murky. At the local level, a might be somewhat higher in China than in Russia. It seems difficult to conclude, however, based on the available evidence, that differences in a are enough to explain the differences in the behavior of local governments in Russia and China.

Turn finally to p, the relative probability of staying in power if pursuing pro-growth policies. In China, the Communist party has the power to appoint and dismiss governors, and it has exercised this power both to support the governors whose regions have performed well economically and to discipline governors who have followed anti-growth policies (see Huang, 1998). Perhaps as an ultimate prize, the governors whose regions perform well have been brought into the national government in Beijing. It is clear that, in China, p is a large number—if the power of the Communist party is viewed as absolute, then p is close to infinity.

In Russia, governors are now elected, not appointed. The ability of the national government to reward or penalize governors through administrative and electoral support has been limited. For this reason, p in Russia is much lower than in China; it is arguably less than one.

This difference in political control, rather than the difference in revenue sharing arrangements, may therefore be the reason why inequality (1) holds for China and not for Russia. For a high enough p, even a low a may sustain pro-growth policies. The Chinese central government has allowed a substantial share of tax revenues, as well as spending responsibilities, to stay with the regions, but, given its power of appointment, it might have gotten away with a lower value of a. For the Russian government, on the other hand, there may have been no value of a that would lead local governments to foster growth. As a result, there may have been little incentive for the central government to maintain a high value of a anyway.

It is interesting to look at the evolution of the relation between central and regional governments in Russia in the 1990s in the light of this model. In the early 1990s, Russia's central government relied on the use of $a > 1$ for most of the regions. It did this by taxing a few oil-producing regions and by using deficit finance to compensate for the resulting lack of net revenues at the center

(Treisman, 1999a). During that period, particularly in 1992–93, Yeltsin also had administrative control over the governors, so p was higher than afterward. As Treisman (1999a) shows, this policy worked tolerably well for a while and bought the center peace with the regions.

In the mid- to late 1990s, that equilibrium fell apart. First, stabilization policies forced the central government to reduce a for most regions, as the central deficit had to be reduced and hence large transfers to the oblasts became unaffordable. Second, political decentralization and party-free gubernatorial elections reduced p significantly. Third, the continued recession reduced at least the expectation of y. In Russia's federal structure today, equation (1) fails, in part because a might be low but also, and more importantly, because p is low. To return to Riker (1964), the peripheralized federalism that characterizes Russia today may simply not be sustainable.

Our focus on the role of political parties in Russia achieving—or not achieving—political centralization may be too narrow. In Russia, two forces have become at least partial substitutes. The first is the national media. Media companies in Russia are private and controlled by interests closely tied to political movements, particularly the government and the center-left opposition. The media groups used television and newspapers aggressively to get their preferred candidates elected in the 1996 presidential election (when both supported Yeltsin) and especially in the 1999 Duma elections. The second centralizing force has been the energy monopolies, especially Gazprom and United Energy Systems. The first holds monopoly over the supply of gas in Russia; the second controls the electricity grid. Both companies, while nominally private, have been close to the government. Both have been used by the government to provide cheap energy, as well as energy without payment, to cooperative regions. In this way, both have been used to make the conduct of regional governments more responsive to the needs of the center. How efficient or desirable these substitutes have been, however, is an open question.

III. Discussion and Implications

Our analysis has a number of implications for China, for Russia, and for the economic theory of federalism. With respect to China, our analysis implies that, to the extent that federalism has played a helpful role in promoting China's economic growth, such federalism relied crucially on the centralizing role of the Communist party.[5] If the Communist party, as it yields power in the future, is not replaced or supplemented by other national parties that influence the appointment or the election prospects of governors, p will fall, leading to greater rent seeking and lower efficiency in its federal arrangements. The message of our analysis for China is clear: the competitive benefits of "market preserving federalism" emphasized by China scholars depend very much on political centralization.

[5]Even in China, control by the center is not absolute. Young (2000) argues, for example, that political centralization has not prevented regional governments from erecting trade barriers between provinces.

With respect to Russia, our analysis suggests that federalism has failed precisely because of political decentralization. There is no question that carefully designed tax and other fiscal policies can raise a in Russia. These policies would require a clearer division of tax bases between the central and the regional governments, as well as a division of tax collection and spending responsibilities that does not exist today.[6] Nevertheless, given the low level of political centralization, such fiscal measures may not be enough to induce local governments to foster growth.

Will centralization come, and if so what form will it take? In principle, centralization in Russia could come through the creation of national parties that exercise influence over the governors needing their support in elections. Centralization may alternatively take the form of greater administrative control over governors through more aggressive bargaining over issues that bear on their regions and remain under the control of the center, such as the allocation of electricity and gas. Centralization may also involve the suspension of the democratic process. Presumably, a turn to a competitive national party system is more compatible with political freedom than are the alternatives. Yet some form of centralization is probably necessary for the federal equilibrium in Russia to change—for a switch in the sign of inequality (1).[7]

From this perspective, Mexico provides a very instructive, though not in every way appealing, example. In the 1920s and 1930s, the Mexican economy presented a far more extreme version of peripheralized federalism than Russia presents today (Diaz-Cayeros, 1997). Following the revolution, the Mexican states were each run by their own dictator, or *cacique*, who controlled the regional sources of military power, collected the regional taxes without remitting them to the center, and erected trade and other barriers against other Mexican states. The result was fiscal disorder and economic stagnation. In 1938, President Calles, with the support of the military, transformed the Partido Revolucionario Institucional (PRI) into a national hegemonic party. He convinced the regional leaders to join the party and to adhere to its national policies with an offer of a carrot and a stick. The carrot was a promise of long, secure, and profitable careers under the protective wing of the PRI, which would gain control over the nomination (and effectively the election) of governors. The stick was a threat of personal violence against the *caciques* who declined to join. Nearly all joined a few who did not were killed. As part of this deal, the central government obtained full centralized control over tax collection in Mexico, leaving the states to rely on transfers from the center, as well as control over trade and regulatory policies that turned Mexico into a common market. The economic benefits of the 1938 arrangement were large, but they did come with tremendous political centralization. It may have been "market preserving federalism," but the political market was not the one that was preserved.

[6]See Shleifer and Treisman (1999) for one such proposal.

[7]This paper was written in December 1999, before President Putin came to power. His regional policies, including those toward governors, have been indeed very much focused on raising p.

The last example leads us to the implication of our analysis for federalism in general. This implication is not new, and draws on Riker (1964), yet it has been neglected in the recent discussions of China praising the decentralization benefits of federalism. As best we can tell, the economic benefits of decentralization obtained from federalism rely crucially on some form of political centralization. Without such centralization, the incentives to pursue regionalist policies are too high, and cannot be eliminated solely through clever economic and fiscal arrangements. It is possible that a federal country can "muddle through" without political centralization, as Russia has done in the 1990s and Brazil and India have done for longer, but some political system of aligning the interests of national and regional politicians is needed to get beyond "muddling through."

REFERENCES

Bardhan, P., D. and D. Mookherjee, 2000, "Capture and Governance at Local and National Levels," *American Economic Review, Papers and Proceedings*, Vol. 90 (May), pp. 135–39.

Diaz-Cayeros, A., 1997, "Political Responses to Regional Inequality: Taxation and Distribution in Mexico" (Ph.D. dissertation; Durham, North Carolina: Duke University).

European Bank for Reconstruction and Development, 1999, *Transition Report 1999: Ten Years of Transition* (London).

Frye, Tomothy, and Andrew Shleifer, 1997, "The Invisible Hand and the Grabbing Hand," *American Economic Review: Papers and Proceedings*, Vol. 87 (May), pp. 354–58.

Huang, Y., 1998, "The Industrial Organization of Chinese Government," Working Paper 99–076 (Cambridge, Massachusetts: Harvard Business School).

Jin, H., Y. Qian, and B. Weingast, 1999, "Regional Decentralization and Fiscal Incentives: Federalism, Chinese Style" (unpublished; College Park, Maryland: University of Maryland, Nobel Symposium on Transition).

Johnson, Simon, Daniel Kaufmann, and Andrei Shleifer, 1997, "The Unofficial Economy in Transition," *Brookings Papers on Economic Activity*: *2,* Brookings Institution, pp. 159–239.

McKinsey Global Institute, 1999, *Russia's Economic Performance* (Moscow: McKinsey).

Oi, J., 1992, "Fiscal Reform and the Economic Foundations of Local State Corporatism in China," *World Politics*, Vol. 45, No. 1 (October) pp. 99–126.

Qian, Y., and B. Weingast, 1997, "Federalism as a Commitment to Preserving Market Incentives," *Journal of Economic Perspectives*, Vol. 11 (Fall), pp. 83–92.

Riker, W., 1964, *Federalism: Origins, Operation, and Significance* (Boston, Massachusetts: Little, Brown).

Roland, G., 2000, *Transition and Economics: Politics, Markets, and Firms* (Cambridge, Massachusetts: MIT Press).

Shleifer, Andrei, 1997, "Schumpeter Lecture: Government in Transition," *European Economic Review*, Vol. 41, No. 3, pp. 385–410.

———, and Daniel Treisman, 1999, *Without a Map: Political Tactics and Economic Reform in Russia* (Cambridge, Massachusetts: MIT Press).

Shleifer, Andrei, and Robert W. Vishny, 1993, "Corruption," *Quarterly Journal of Economics*, Vol. 108 (August), pp. 599–617.

Treisman, Daniel, 1999a, *After the Deluge: Regional Crisses and Politicat Consolidation in Russia* (Ann Arbor, Michigan: University of Michigan Press).

———, 1999b, "Decentralization, Tax Evasion, and the Underground Economy: A Model with Evidence from Russia" (unpublished; Los Angeles, California: Department of Economics, University of California).

Wong, C., ed. 1997, *Financing Local Government in the People's Republic of China* (Hong Kong SAR: Oxford University Press).

Young, A., 2000, "The Razor's Edge: Distortions, Incremental Reform and the Theory of the Second Best in the People's Republic of China," *Quarterly Journal of Economics*, Vol. 115 (November), pp. 1091–135.

Zhuravskaya, E., 2000, "Incentives to Provide Local Public Goods: Fiscal Federalism, Russian Style," *Journal of Public Economics*, Vol. 76, No. 3, pp. 337–68.