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The Presence of Soft Budget Constraints Preconditions in Russian Regions

3.1. Introduction

One of the leading explanations of pathologies of central planning system is based on the theory of soft budget constraint put forward by Kornai (1980). His theory involves three main actors, softly restrained enterprises, their creditors and a 'paternalistic' state. Firms' willingness to run up debt, financed by creditors, is sustained by expectations of rescue by the state. Nowadays, the existence of this phenomenon is evident in all polities, though more vividly in transition economies. Maskin and Xu (2001, 10) show that the SBC syndrome continues to play an important role in economic life in all countries in Eastern Europe and the former Soviet Union, even those that have already undergone a long period of reform. Much of the existing research, however, has focused on SBC between the state and enterprises, while here we are interested in regional governments in a federal system. In the chapter, therefore I explore the theoretical preconditions for the emergence of soft budget constraint at sub-national level. Following this, narrowing the focus, I identify the preconditions that increased the likelihood of regional governments in Russia 'enjoying' SBC conditions.

3.2. Theoretical Approaches in Analyzing the SBC Conditions on Firms

Only relatively recently have SBC as imposed on agents other than enterprises (administrative bodies, sub-national governments) begun to attract the attention of researchers. Consequently, the approaches of analyzing the conditions and implications of SBC for governments of sub-national units are based to a large degree on approaches taken from the analysis of SBC imposed on firms. Since it was the analysis of SBC on enterprise level that set the path for a broader scope of studies of SBC in general, it is worth giving a brief overview of the literature

The term of SBC was first coined by Kornai in his book of the behavior of economic units in planned economies (1980, 1986). The box below provides a brief overview of the main focal points of his theory.

A firm on a market experiences three types of constraints in its pursuit of profit maximization: resource constraint, demand constraint and budget constraint. The last refers to the rule that expenditures of the firm cannot exceed its financial capital and revenues from sales. In Kornai's view, the difference between market and socialist planned economies is that in the latter resource constraint is more important than demand constraint in defining the amount of goods to be produced by a firm. In a market economy, the demand constraint is efficient: no more goods are produced than buyers are willing to purchase.

But at the core of Kornai's theory is the difference between the two types of economies with respect to the budget constraint. In market economies, firms experience hard budget constraints: they go bankrupt if expenditures exceed revenue. In a planned economy the state is unwilling to let enterprises fail, providing them with soft budget constraints. The paternalistic state bails out firms either by direct financing of deficits, or setting low prices for the resources that the firm uses, or fixing high prices for the firm's production, or exempting it from all or part of the taxes it should pay.

Because a state guarantees the survival of the firm, this 'negatively' affects the incentives and behavior of managers, who invest in various inefficient projects, or waste resources with no fear of future financial difficulties. The growth of the firm is not constrained either by demand or budget constraints. Prices for input resources do not affect the demand of a firm, which causes that demand to be absolutely inelastic with respect to prices. The only constraint which prevents firms from unlimited growth is the resource constraint. This behavior is guided by the *expectations* induced by the government's paternalistic concerns. The firm's efforts towards expansion force them to purchase all input goods at any price, and this explains the pervasive deficit in a planned economy.

The central argument of the subsequent literature (Kornai 1980, Besfamille and Lockwood 2004, Dewatripont and Maskin 1995, Kornai, Maskin and Roland 2003) is that soft budget constraints arise because politicians cannot commit *not* to refinance bad projects *ex post* and cannot distinguish bad from good *ex ante*. Robinson and Torvik (2006) argue that the reason why SBC persist is that they serve the interests of politicians, and that the key point about the soft budget constraint is that it is a credible way of transferring benefits to potential supporters. Their main observation that a policymaker cannot commit to enforce a hard budget constraint, but that he can commit to make transfers to citizens, is applicable to intergovernmental relations in the realm of fiscal relations.

In case of the Russian Federation, the SBC were supported not only vertically, by the state, but laterally, by creditors, and institutionally by the file card system, which survived until

mid-1992. Under this system, payments were made almost automatically, were managed by banks, and as long as there were some funds in the account, the bills were paid in order of their receipt. Moreover, in Russia the constraints for enterprises remained soft even after the card file system was abolished, since firms continued to believe that even if there were no money in the debtor's account, the state would step in and settle the obligations.

The requirement of the hard budget constraint (HBC), or strict limitation of revenue-sharing between the levels if a federation is to be market-preserving, has some important limitations for the Russian case. Weingast's (1995) concept of soft budget constraint goes beyond this narrow interpretation: it is the propensity and capability of the regional governments to remove/ignore obligation to balance revenues and expenditures.¹ SBC conditions therefore encompass a recurrent pattern of extra-constitutional revenue-sharing between levels, and are characterized by governments' stable expectation of a central bailout in the event of insolvency.

3.2.2 Theoretical Preconditions for Soft Budget Constraint of Sub-national Governments: this section (in small font) will be written later

Inman (2003) frames the main preconditions necessary for the softening of soft budget constraints in a formal game: the national authority's optimal strategy includes the decentralization of tax powers and provision of public goods to the lower level with the *ex ante* strategy of limiting the provision of additional aid. But because the voters of the regional politicians are at the same time the voters of the national politicians, this makes it preferable for the national authorities to infringe on earlier announced principles and grant unplanned financial resources if a region runs a budgetary deficit. Sub-national governments, in turn, would intentionally increase provision of public goods above optimum on expectations of additional national aid. Both of these conditions describe the structure of strategies of two agents conducive to SBC, but say little about the structural and institutional preconditions. Sinelnikov-Murylev et al. (2006) outlined a comprehensive list of preconditions for SBC for sub-national governments, which are presented below in a box.

(i) Vertical Imbalances Between the Levels of the Government

One of the institutional prerequisites is the fiscal vertical imbalance caused by the situation where devolution of expenditure obligations exceeds the degree of delegation of revenue powers. This imbalance creates the preconditions for the SBC and also creates incentives on the part of sub-national government for extra-

¹ According to Lavrov et al. (1997) in 1996, regional budget revenues had grown by 1.38, while tax collections - by 1.43, the transfers and other revenue sharing between the levels of federation had grown by 1, 57 (Lavrov et al., 1997, 55).

borrowing (Garcia-Mila, Goodspeed and McGuire, 2002). The formal model described by them is based on the assumption that sub-national borrowing is financed by central government by raising the rate of national tax. But the amount of taxes borne by the regional taxpayer does not grow proportionally to the amount of financial aid, but at a diminishing rate. That makes the incentives for borrowing very attractive, because for the region as a whole, the tax price for additional borrowing diminishes with the amount of borrowing.

(ii) The Lack of Fiscal Decision Making Capacity of the Sub-national Governments

Even in a situation of perfect match between the revenue powers and expenditure obligations, the scope of the sub-national decision-making power in the sphere of taxation can be insufficient for budgetary independence. In a situation of financial difficulty the sub-national governments will have very limited institutional capacity to adjust to worsened circumstances. The lack of decision-making power prevents them from choosing their own revenue sources and tax rates finely tuned to the problem at hand.

(iii) The Lack of Established Procedures for Granting Intergovernmental Financial Aid

Even these two types of imbalances may be prevented from softening budget constraints if the “system of interbudgetary transfers is not based on discretionary decisions, but is in a framework of legislatively set and strongly enforced procedures” (27). Where transfers are allocated according to clear formulae and unambiguous criteria, the budget constraints remain hard. But in cases where these criteria are unstable, and there are no clearly defined procedures for granting financial aid, these criteria can be manipulated in favor of individual regions at the expense of others. “[S]ub-national authorities have the possibility to persuade the national authorities to provide additional funds in the framework of the national system of financial support” (29).

(iv) The Existence of Joint Responsibility for Provision of Public Goods

In federal states it is common for the sub-national level of government to take responsibility for providing minimum social standards of living on their respective territories. However, the expenditure mandates adopted at national level often stipulate that both levels of government bear joint responsibility for the provision of public goods. In this case, the electorate of the regions will hold accountable both levels of government in the case of failure to provide key public services. The federal government will find it increasingly difficult to harden budget constraints in the presence of legislative restrictions (Vigneault, 2003) on doing so.

(v) Information Asymmetries

Sub-national governments often have incentives to withhold or hide the information on the fiscal processes at their level from both the electorate and the national authorities. “Sub-national authorities on their own initiative often facilitate non-transparency of fiscal reporting” (31). By skillfully complicating the budgetary process and masking the real costs and benefits of certain fiscal policies, they can shift responsibility for the inefficiencies up to national level. This situation is a strong precondition for the national authorities to bail out the sub-national unit.

(vi) Pressing Political Objectives

The central authorities can themselves be inclined to grant SBC conditions for some regions as long as in exchange they receive other types of support, more important given the current political situation. These types of exchange are especially typical during electoral campaigns: the federal centre often uses the SBC condition as a reward for the support of regional voters in competitive elections.

(vii) Lack of Limit on Sub-national Borrowing

(viii) Structure of the Governments

In many federal states, the upper house of parliament is composed of representatives from the sub-national units. Due to political lobbying and interregional cooperation, soft budget constraints can be legalized at the national level. The SBC conditions can be granted for individual regions in exchange for support for other policy decisions (Alesina, Perotti, 1999, Rodden, 2001).

The case of universal softening of budget constraints is more complicated, but even financially stable regions can be tempted to vote in favor of increasing additional financial support, as long as this increase is financed by an increase in the share of the federal centre in shared taxes.

I will draw this classification in the next section, with only two additional preconditions: (ix) heterogeneity between the regions and (x) the attributes of the median region/voter, conducive for the SBC

(ix) Not every form of financial assistance for the sub-national unit indicates that budget constraints are softened for that agent. On the contrary, the horizontal imbalances are the justification for additional financial aid for backward regions. But the extreme heterogeneity of the regions makes it difficult to evaluate a fair amount of transfers from the centre, and therefore it can be considered as a precondition of SBC.

Heterogeneity between the regions has received relatively little attention in studies of federalist bargaining (Riker 1964, de Figueiredo and Weingast 1997, Ordeshook and Shvetsova 1996, Weingast 1997, Solnick 2000). The last two are exceptions: while Weingast (1997) only mentions that highly diverse sub-national units can be a source of the adverse exploitative outcomes, Solnick's work is based on the investigation of how heterogeneity between the regions forced the central government to concede uniformity in treating them. The asymmetrical institutions that emerged as a result did indeed help to hold Russia together in the short run, but in the long run they weakened the legitimacy of federal laws, undermined the protection of civil rights and prevented the potential economic benefits of federalism that would have stimulated the developments of markets. The asymmetrical granting of the SBC conditions was a fundamental obstacle on the way to market-preserving federalism (Solnick, 2000).

(x) This precondition is closely related to the eighth one, since it draws on the ability of regional leaders to access to nation-wide decision making. Each region have a representative(s) in the legislature, who conveys the interest of this particular region into the policy-making process. If the structure of the federation over represent relatively poor, and highly specialized regions (even if in terms of population they are in minority), the structure of preferences of a median voter in the national legislature would be conducive for the SBC.

3.3. Russian regions in 1996. Were these preconditions in place?

This section will demonstrate that the features of Russian fiscal system, the profile of the political institutions and the peculiarities of the political situations met all theoretical preconditions for the emergence of the SBC.

It is worth noting that in abovementioned classification the regional financial difficulties are described as an outcome of growth of expenditures (usually for the provision of public goods). In the Russian regions, as regards the period 1996, the budget deficit was more often a result of ineffective spending than just an increase in volume of provision of public goods. Moreover, in many cases, it was caused by a shrinkage of revenues rather than a growth in expenditures. *As was noted by the Pinto et al. (2000), the major source of SBC in the 1990s was federal centre's tolerance of the regional tax arrears. However these deviations do not affect adversely the applicability of these preconditions to the Russian regions.*

First, the Russian case meets the condition of the vertical imbalance perfectly. While the Russian laws vest broad powers in the federal government, most of the obligations for provision of public goods are delegated to regional level. Partly, this can be explained by the situation in 1992-1993, when regional budgets were not running a deficit, while the federal budget was deeply insolvent. It is understandable that in this situation the federal authorities pushed spending responsibilities down to the regional level. The early reform government believed that regional governments would be subject to self-imposed hard budget constraints. But instead of that, because of the mismatch between rights and obligations, regional authorities acquired an 'informal right' to seek SBC condition to cover the deficit.²

Second, the precondition of the lack of decision-making power in the fiscal sphere is in place too. The degree of autonomy with respect to definition of tax bases and rates is quite low in the Russian case. By defining the levels of taxation and the rules for calculating the tax base, especially VAT and profit tax, the central government efficiently 'crowded out' the institutional capacities of the regional governments in this sphere. The regions experienced limited fiscal autonomy, and even though they had discretion over other tax bases and tax rates, their fiscal decision-making powers were restricted by the federal centre. This limits the ability of regions to help themselves (Hanson et al. 2000, 104). The lack of flexibility in tax-

² The vertical imbalances, for example were the alleged cause of the permanent deficit of the budget of the Saratov oblast, mounting to 6 percent of the revenue part (Abdulatipov, 2003)

related policy making diminished the capacity of the sub-national authorities to take full responsibility in cases where they ran a deficit. This imbalance also creates incentives for extra borrowing on the part of sub-national governments. Over the years they found various ways to spend more than they collected, issuing regional bonds, bills of exchange (*veksels*), and using tax-offsets and combinations of transfers from off-budget funds (Hanson et al. 2000, 110). The absence of laws and regulations introducing caps for a maximal amount of borrowing approximate the seventh precondition. Limited powers to levy taxes in their territories, coupled with an imbalance between rights and obligations, put the federal government under double pressure from the regional electorate and creditors of the regional governments, who were inclined to delegate the responsibility for solvency crises to the federal authority. These two first preconditions are in line with the argument of high likelihood of policy divergence in federal settings and particularly with respect to economic reform (Wibbels 2000, Prud'homme 1995). It is explained by the fact that electorates see federal, not regional government as responsible for macroeconomic performance and lack of proper provision of public goods. Because regional governments more often than not are protected from accountability for the overall macroeconomic situation, the soft budget constraints are particularly easy to elicit in times of macroeconomic instability, which was the case in 1996-1999.

Third, though Russian fiscal practices were becoming more routinized by 1996, even core tax ratios and formulae for the granting of financial aid were subject to frequent alterations. The Art. 50 of the Budget Code, that states that the ratio of the federal and regional shares in shared taxes are to be set stable for the period of at least three years, was constantly violated, as they were renegotiated annually, and in some years, semi-annually (Abdulatipov, 2003).

Criteria for granting transfers from the federal level to the regional were not clearly defined from the outset, in large part, they were calculated on the basis of the transfers from previous years (Popov, 2004).³ Since 1994, the law on the federal budget identified a fixed amount of financial assistance to each region on the basis of the formula. But the parameters in the then

³ Popov argues that federal in 2001 authorities manipulated the expenditure part of the formula of the transfers, to make sure that pro-Yeltsin voting regions, Moscow and AOs could leave more taxes in the region and transmit less to the centre, following the pattern in 1994-1999. The more the region was paying to the centre in 1994-1999, the lower level of expenditure need was established, so that less taxes could remain on these territories. '(T)he indices for of budgetary expenditure for the 2001 RF budget were computed in such a way as to incorporate these actual pattern of transfers, i.e. to make sure that there is no need to alter the existing pattern of financial flows drastically' (Popov, 2004, 7)

existing formula were not based on objective calculations. For example, the expenditure need indicator was computed by indexing to the inflation level of the 1991 budgetary expenditures on the respective needs (Sinelnikov et al, 2006). Thus allocation of planned financial assistance was based on characteristics endogenous to the regional governments' policy choices. These transfers were only part of the story, as unplanned federal transfers, the tax concessions and tax exemptions, which accounted to asymmetrical nature of the Russian fiscal relations, were granted in an absolutely arbitrary fashion.

Fourth, like in a majority of federal states, the federal and sub-national levels of government have joint responsibility for provision of key public services in territories. The bulk of the expenditure obligations for fulfillment of the social and economic policies is borne jointly by the federal and regional authorities. Especially troublesome for the regional governments is the situation with non-financed federal mandates. These mandates stipulate the amount of spending on the provision of public goods, without indicating corresponding sources of financing. The provision of financial aid for particular social groups constitutes a substantial part of those non-financed mandates: 150 federal laws, 40 of which dated back before 1992, impose on regional governments, while it was at the discretion of the latter to find necessary revenue sources⁴.

The fifth requirement concerns the level of information asymmetry. Gilbert (2001) investigated the informational asymmetry in relationships between the federal centre and sub-national units in a framework of principal-agent model. He found that in the Russian case, the verification of the justifiability of the amounts of transfers a region is entitled to is very costly due to insufficient information transparency and an underdeveloped institutional environment. In their pursuit of the extra financial funds, the regional governments often provided the federal centre with information distorted in their favor. Instead of accepting that the budget deficit was caused by ineffective spending, they tried to convince the federal centre that objective factors were behind the expanded spending. One of the most cited examples is the case of Primorskiy krai, where funds earmarked for financing the system of central heating of residential housing were used elsewhere. The consequent emergency situation, with several thousand lives at risk, was presented as a strong reason for bailing out the deficient budget

⁴ It has been proved by the Fund of the "Institute of the Urban Economics" that the amount of the payments exceeded the revenue part of the consolidated budgets by 70 percent, and would constitute 22 percent of GNP (Gigolo, 2000)

(Zhuravskaya, 2002). In cases such as the Sakha republic and Kamchatskaya oblast', natural disasters such as river floods or other objective circumstances were used to back up applications for extra transfers. The information costs vary from case to case, and in some regions it was too expensive for the federal government to closely monitor the real developments in the regions. In many cases it was less costly for the federal centre to grant SBC conditions to the (supposedly) needy region than embark on expensive verification of the actual amount needed.

Sixth, the political situation in early and mid-90s was particularly conducive to SBC. In 1992-1993, republics and some regions sought to build up their sovereignty at the expense of a weakened centre. The parade of sovereignties starting from the case of Tatarstan in 1992 was followed by a sequence of bi-lateral treaties in 1994. These developments coincided with an increase in federal budget transfers to the regions from 1.7 to 3.8 per cent of GDP in the years 1993 and 1994. The presidential election in 1996 was a particularly pressing political issue. The end of 1995 and the first half of 1996 were marked by an unprecedented decline in the popularity of the central government in the eyes of the national electorate. The war in Chechnya and failure to provide economic stabilization were blamed on Yeltsin's inability to effectively fulfill his duties as a president. In January 1996, just six months prior to elections, Yeltsin's poll rating was as low as three percent (Aslund, 2007, 165). With this level of unpopularity, the support of the regions was essential, which was achieved in most cases via softening of budget constraint.

The eighth precondition, namely the particular structure of government mentioned above was also present, granting regional representatives access to national decision-making.

As far as heterogeneity is concerned, the Russian federation is a paramount example of extreme heterogeneity among its constituents. The diversity of the Russian regions makes it virtually impossible to completely eliminate revenue sharing between levels of government. It is thus institutionalized in the form of the Federal Fund for Support to Regions (FFSR) supposed to even out economic and social inequality through equalizing transfers. This approximates the last requirement.

The tenth precondition was apparent: the territorial patterns of economic development did not follow the logic of economic efficiency; they were the result of the pre-Soviet politics of

occupation and control and the Soviet planning system, which allocated industries regardless of the future costs and benefits. The highly centralized economic system provided parity of economic activities between regions via pricing and subsidizing, but when this system collapsed, the problem of economic integration at regional level became overwhelming. Icker and Ofer (2006) documented that the distribution of regions with regard to their economic efficiency is highly skewed toward less efficient ones, which means that the median voter would be unable to achieve economic viability without central financial aid. Since each constituent unit has an equal vote, the median one votes for the revenue sharing and subsidies.

3.4. Conclusion

Though Sinelnikov et al (2006) developed comprehensive and robust classification of SBC on sub-national governments, this classification has hitherto not been applied to the Russian case. *I also added two important additional preconditions to the list: heterogeneity between the regions and the attributes of the median region/voter, conducive for the SBC.*

Through the application of their taxonomy to the situation in Russia in the mid-nineties, this chapter has shown that all the theoretical preconditions for the soft budget constraints outlined in section 3.2 were indeed in place. Such economic outcomes as slow economic growth, capital flight, and lack of investment are produced by incentives embodied in the softness of budget constraint. The combination of the almost clandestine tax-sharing agreements and unclear rules for the federal budget transfers made it nearly impossible to achieve trust and agreement between the regions and the centre. No clear division of responsibilities between the levels of the government was drawn, and these responsibilities did not correspond with the revenue-raising powers. With these boundaries blurred, and the level of responsibilities not matched with powers to levy taxes, it was more rational for regions with greater relative bargaining power not to look downward to generate their own resources, but to lobby the central authorities for tax benefits and transfers. Tracing the history of Russian fiscal policies, what is most striking is the selectivity with which the federal government treated its constituents.

The federal Tax Ministry collected revenue from regions, and a fixed percentage of core taxes were transmitted to the federal budget. But these rules were by no means uniform, and several

regions forced the federal centre to concede more preferential rates. Occurrences of bailouts, as well as the existence of federal legal regulation on the procedure for granting tax concession to regions, point to the fact that central government took resources from some regions and bailed out others. Following redistributive logic, this makes regional government “expend political energy trying to maximise what it obtains from the centre and minimising what it gives up” (Burawoy, 1996, 1107). Those regions that stood a better chance of winning a bargain with the centre rather than investing in regional economic development sought to “retain control over its own territorial resources even if it means concealing the amount it produces”(Ibid, 1108).