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Fiscal Decentralization in the Russian Federation during the Transition

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FISCAL DECENTRALIZATION IN THE RUSSIAN FEDERATION DURING THE TRANSITION

Jorge Martinez-Vazquez and Jameson Boex

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CHAPTER I

THE DYNAMICS OF DECENTRALIZATION IN THE RUSSIAN FEDERATION

Intergovernmental fiscal relations may be the most contentious issue in the Russian Federation today. This is the result of the complexity of the problems intertwined with intergovernmental relations. These problems include the recent history of disintegration of the Soviet Union; the war in Chechnya; the ethno-linguistic, religious and historical differences across its vast territory; great variations in the endowment of mineral resources; increasingly large economic and fiscal disparities across regions and local governments; and the spreading sentiment in some regions that they can be better off by seceding from the Federation. It is not an overstatement to say that the survival of the Russian nation itself depends on the establishment of a system of intergovernmental fiscal relations that is functional and appropriate.

At the time of independence it was generally accepted that a federative form of government was the only political system that would fit the size and diversity of the country (Polishchuk, 1996). There was less consensus on what form the federation should take. Since its conception, there has been overwhelming and continued pressure for decentralization in Russia. However, the motivations behind this push for decentralization have been both positive, such as the desire to achieve a more efficient and fair government, but in many cases also negative, resulting from a lack of national solidarity and regions intent on prevailing over common national interests. In an environment of political instability and economic transition, the negative motives seem to have dominated the evolution of the system of intergovernmental relations in Russia.

There has been a significant difference between the legislated system of intergovernmental relations and reality. On paper, a transparent and symmetric system of intergovernmental relations was developed in the years after the disintegration of the Soviet Union. Previously differentiated sharing rates for shared taxes were standardized and a formula-driven equalization mechanism was introduced to replace a system of negotiated transfers, while Articles 71 and 72 of the Constitution assigned expenditure responsibilities between the federal government and the “subjects of the Federation.”¹ In reality, there exists general

¹ According to the Russian Constitution of 1993, the Russian Federation comprises 89 subnational regions or “subjects of the Federation,” including 49 oblasts, 21 republics, 6 krai and 2 cities (Moscow and St. Petersburg). In addition, the Russian Federation contains 11 autonomous oblasts, or okrugs. These okrugs are actually sub-units within larger oblasts, but they are independent from these oblasts for fiscal and budgetary purposes. One of the 21 republics, Chechnya, for all intents and purposes is not a participating member of the federation and will therefore be left out of the current discussion. Hence, there are 88 regions, or subjects of the Federation, with which the federal government maintains regular fiscal relations. The term “oblast” is often used more broadly to refer to all regional governments, including republics, krais, cities and okrugs.

confusion, dissatisfaction and even open political conflict between the federal government and the regions (and in some cases, between the regions and local governments). Since independence from the Soviet Union, the federal government has struggled for power with the regional governments. This power struggle has been facilitated by the ambiguity with which expenditure responsibilities are assigned in the Constitution and the large number of bilateral fiscal arrangements between the federal government and individual regions, which together have watered down both the transparency as well as the symmetry in intergovernmental fiscal relations in Russia.

1.1 The Forces behind Decentralization in the Russian Federation

The basic economic argument for decentralization in Russia is identical to that in other countries in transition, namely the failure of the socialist economic model and the centralized government control that it represented. More generally, fiscal decentralization in Russia has been fueled by the belief that decentralization is an effective way for increasing the efficiency of government and strengthening democratic institutions. Until very recently, much less attention was paid to some of the risks associated with greater decentralization such as a more unequal distribution of resources and the possibility of compromising macroeconomic stability.

The dynamics of decentralization in Russia has involved elements of delegation, or a “top down” process by which the federal government has delegated a number of expenditure responsibilities to the regions which are subject to strict federal expenditure guidelines, while granting only very limited own revenue-raising abilities to subnational governments. The use of delegation as a means of decentralization provided both for continued centralized control over expenditures as well as providing federal budget relief, as delegation of expenditure responsibilities frequently did not come with adequate additional funding or assignment of additional revenue sources (Igudin, 1998). The process of decentralization in Russia also contains elements of devolution or the “bottom up” approach to decentralization, in which regional governments have gained a constitutional right to govern their own affairs and to formulate and execute their own budgets, with little meddling so far from the federal authorities. These elements give Russia features of a federal system.²

This mix of decentralization models is conspicuous in the 1993 Constitution which is deliberately obscure regarding whether power originates at the center or in the regions (Teague, 1996). In reality,

² Not everyone will agree with the definition of Russia’s regime as a federation. McLure et al. (1996) remark that the Russian Federation is a federation in little more than name because of the very few legal powers and the virtual lack of revenue autonomy of the regions. For instance, China, whose approach to intergovernmental relations is similar in many ways to Russia, is a unitary country. At the same time, in actuality many Russian regions on different occasions have claimed *de facto* powers akin to those of a confederation, such as refusing to remit tax collections to the center or taking over the responsibilities of the federal government in the regions. This type of fiscal relation characterized by confrontation and at times chaotic claims to power have been described as “fiscal feudalism” in Russia (Lavrov, 1998).

power is shared, but its division is far from having been decided. Given the basic unresolved issue of where power originates, a safety valve in the 1993 Constitution allowed the federal government to enter into bilateral treaties with regional governments. With the onset of the first treaties in 1994 it was clear that the regions could factually circumvent the Constitution (OECD, 1997 and Teague, 1996). This was also evidenced in the regional constitutions and statutes approved by the regional legislatures. The favorable treatment given to ethnic republics, such as Tatarstan and Bashkortostan, created resentment and imitators among many other regions. This has led to the evolution of asymmetric federalism in which some regions are more equal than others in terms of the resources they get to keep rather than remit to the center.

Political Factors

The process of reform of the system of intergovernmental fiscal relations in Russia involves many questions and issues of an economic and technical nature, but this process has been and continues to be foremost a political process. The relevance of politics in the Russian Federation is without doubt connected to its vast territory, very significant disparities in industrial development and resource endowments, and its ethno-linguistic diversity. These factors continue to exert significant centrifugal forces on the country. The natural case against these centrifugal forces should come from an integrated economy that allows growth and prosperity in a way that makes being part of the whole more beneficial than regional autonomy or independence. Unfortunately, the transition to a market economy has failed so far to bring the required economic growth and prosperity to all or even to a majority of the regions.

As we recall, the Russian Federation was created out of the process of disintegration of the Soviet Union when Russia and other former Soviet republics refused to remit tax revenues to the Soviet government in Moscow, proclaimed that their laws took precedence over Soviet laws and ultimately declared themselves independent. This process led to a weak political start for the Russian Federation because it gave opportunity to the autonomous republics within Russia also to declare independence or to assert high degrees of autonomy (Teague, 1996). The assertiveness of the regions, especially the ethnic republics,³ to grab more power grew bolder during 1992-93 as the President and Parliament (the Supreme Soviet) were involved in a power struggle of their own.

As a stopgap measure the Federation Treaty was signed in March 1992 to regulate the relationships between the federal and regional governments, but two republics (Tatarstan and Bashkortostan) refused to sign it. As would happen again with the 1993 Constitution, the Federation Treaty left the issues of the division of power between the federal and regional governments unresolved. Although the ethnic republics were given some additional powers in the Federation Treaty, these were taken away in the 1993 Constitution.

³ Of the 21 ethnic republics only six actually have a majority ethnic population. In fact, in many of the 21 ethnic republics the majority of the population is Russian.

Increasingly, regional positions on federation issues and federal policies have been prone to split along the lines of “have” and “have-not” regions. These two groups are formed around the so-called “donor” regions, which contribute more in overall taxes than they get back in revenue sharing and transfers, and “subsidy” regions, which receive a net inflow of funds from Moscow. The group of “donor” regions has varied with transfer and revenue sharing policies but includes Moscow City, St. Petersburg, Nizhny Novgorod, Samara, Sverdlovsk, Volgograd, Tyumen, Khanty-Mansi, Krasnoyarsk, and Sakha (Yakutia). A formal association of these regions has been promoted by the mayor of Moscow, Mr. Luzhkov. Although regions have entered large geographical associations to bargain with the federal government (the Northwest, the Volga basin, the Central-Black Earth, the Urals, and the Siberian associations) it is the “donor” versus “subsidy” divide that increasingly dominates the political process.

Not surprisingly, the element of devolution has gained importance in the decentralization process as democratic institutions have developed at the subnational level. A significant shift in the balance of power between the federal government and the regions came with the 1993 Constitution and a subsequent law which required that by the end of 1996 all subjects of the Federation had to have popularly elected heads of the executive. All regions but five complied with the deadline and the rest of the elections followed in 1997. While previously many regions had been amenable to following orders, the election of regional governors left the federal authorities in a position of having to negotiate with each one of the regions.

Negative centrifugal forces have gained momentum in part due to the failure of federal authorities to provide enough funding for basic services and also due to the perception in the regions that abuse, fraud and cronyism abound in Moscow. Separatist demands and open opposition to federal government policies by some regions have been common over the past six years. These demands have been more pronounced in some regions than in others. Regional strength vis-a-vis the center got a very significant boost by the vacuum of power created by the financial crisis and the dismissal of Kiriienko’s administration in August 1998. This time, as in the earlier years of the transition, several regions declared they would stop remitting funds to Moscow. Several others introduced price controls and prohibited the export of food supplies from the region, while Kaliningrad even intended to declare a state of emergency.

Asymmetric Federalism

In response to regional opposition and centrifugal forces, the federal government appears to have offered systematically more advantages and privileges to the politically “difficult” regions. This type of response has created an asymmetric federalist system (Wallich 1994), a pattern that clearly emerged in 1992. Many researchers have documented this pattern of advantageous fiscal flows to difficult regions.⁴

⁴ Treisman (1996 and 1998b) and others have remarked on the important role that separatist demands have played in the actual flow of fiscal resources between the center and the regions in Russia. A pattern of favoring the 21 ethnic republics over the other regions in the form of larger subsidies, permission to retain a higher share of tax collections, and special decrees granting economic benefits, was

Asymmetric federalism, taking the form of particular political and economic arrangements, is frequently regarded as a flexible policy that accommodates regional diversity as in the case of Canada or Spain over the past 20 years (McLure et al., 1996). Asymmetrical federalism has also been heralded as a positive way to address the growing conflict of interest and growing divergence between richer regions, with stronger economic bases and more incentives to resist interregional distributions, and poorer regions which are becoming increasingly dependent on federal transfers (Freinkman et. al., 1998).

This asymmetric treatment of subjects of the Federation would not appear to be unconstitutional.⁵ The ambiguity in Articles 71 and 72 of the 1993 Constitution concerning the division of powers between the federal government and the regions, as well as provisions in the Constitution allowing the federal authorities to enter into bilateral agreements with separate regions all seem to point to the legality of asymmetrical federalism. Bilateral agreements provide a contractual framework between the federal government and a region within which detailed functional agreements are stipulated. The functional areas covered by these bilateral agreements include budgetary relations (expenditure and revenue assignments), state property, sectoral regulations, ownership and use of natural resources, environmental protection and regional migration. Until 1995, these treaties were used for the clarification of intergovernmental fiscal relations between the Federation and the ethnic republics.

While legal, such bilateral agreements created a good deal of resentment among mono-ethnic regions. Starting in 1995 their use was expanded to cover other types of regions (oblasts, krais, okrugs and city regions) as well. The expanded use of bilateral treaties to cover other types of regions was caused by increased pressure and resentment from these regions and coincided with the presidential election campaign in the first half of 1996. Consequently, the federal government has been involved in a simultaneous bargaining game in which concessions to one region affect those that have to be granted to other regions; asymmetric results followed because not all participants had the same degree of credibility and bargaining power (Solnick, 1995). The pattern of results seems to show that Moscow has tended to reward rather than punish those regions that were or have been more defiant.

As a result, asymmetric federalism has caused a situation where all regions have an incentive to deviate from federal laws and press for more special treatment which, at the same time, leads to a weaker government and probably to worse economic situations for all regions (Treisman, 1996). Why is it then that the federal authorities have chosen asymmetric federalism which keeps in motion a mechanism for disunion and resentment among the regions, and which may eventually bring about the auto-disintegration of the Russian Federation? Solnick (1995) argues that the inability of the federal authorities to enforce the rules may have eroded the reputation of the federal government. The fear of the lack of ability to impose universal rules may have caused the federal government to consider independent bilateral negotiations a

identified by several authors (Lavrov, 1995).

⁵ The 1993 Constitution itself declared all subjects of the Federation equal, but it also granted the ethnic republics special rights such as passing their own constitutions and electing their heads of government. However, these same rights in one form or another were also given to all the other regions.

superior solution. Moscow's strategy to buy the consent of the less cooperative regions indicates that asymmetric federalism is not necessarily a superior solution but one that has been imposed on the federal government by political reality. Prior to the implementation of bilateral treaties there was a constant resistance if not outright opposition to fiscal discipline by some subnational governments. The bilateral arrangements have had the strategic effect of weakening any coordinated action and demands by the ethnic republics and may have prevented the cessation of Tatarstan. As a result, the net impact of asymmetric federalism has been to foster, but also to help control, the centrifugal forces in Russia. Also, the bilateral agreements appear to be only one of several causes of the poor fiscal incentives and poor revenue collections at the subnational level.

The most significant feature of the past six years in Russia has been the lack of a coherent vision for decentralization. With hindsight, one notes that the differences in views and positions of various regions have made it impossible to create a consensus. The events of the past six years will make it even harder to develop a consensus on the overall strategy for reform and to find an appropriate balance among key objectives underpinning the decentralization policy: fairness in the allocation of resources across regions, the promotion of growth and a more efficient allocation of resources, the preservation of macroeconomic stability and fiscal and monetary discipline. The process of defining an overall strategy for the reform of intergovernmental fiscal relations and the weighting of the different objectives to be pursued in this reform should be expected to continue to be difficult and slow, if at all possible, given the diverging interests between regions and the significant difficulties by the federal government to restore growth and prosperity in the country.

1.2 A Historical Overview of Intergovernmental Fiscal Relations Since 1992

An integral part of the Russian transition to a market-based economy has been the decentralization of government functions. The road to meaningful decentralization is proving to be a difficult one for Russia. Three main phases can be distinguished in this process of decentralization, namely (i) the early years of the transition (1992-93), (ii) the reform process started in 1994, and (iii) more recent reform policies (1997-98). The role of politics, which has been central in defining each of these phases of decentralization policy, will be discussed following the historical overview.

The early years of the transition (1992-93)

This early period of decentralization can be best characterized as a continuation of the approaches and practices inherited from the Soviet Union. Subnational budgets were based on negotiated expenditure norms. Customized revenue sharing rates and bargained transfers were used to fund the budgets of all subnational governments. The major change in this period was the shifting down to subnational governments of financing responsibilities for expenditures that in the past had been the responsibility of the federal government, including price subsidies for food and other goods, such as medicines, local transportation and public utilities. This meant a significant increase in the involvement of subnational governments in the economic sphere. During this period, responsibility for many of the social welfare policies was also

transferred to subnational governments. In addition, the federal government delegated responsibilities for capital investment in many different areas to the regions.

The greater expenditure responsibilities of subnational governments were accompanied by an increase in the subnational governments' share in overall government expenditures and an increase in the importance of intergovernmental transfers. These changes occurred against a background of a drastic decrease in the involvement of the public sector in the economy; overall public sector expenditures decreased from 52 percent of GDP in 1992 to 42 percent by 1994.

Regional governments received funding from three different sources: first, their own revenues generated from regional and local taxes; second, the sharing of revenues from the major taxes (the enterprise profit tax (EPT), individual income tax, VAT, and excise taxes); and third, transfers.⁶

Only a small degree of budgetary autonomy was granted at the subnational level giving regions and local governments discretion on how to spend their budget funds.⁷ The most significant factor standing in the way of full decentralization was, in fact, that regional and local governments were given little revenue raising authority. Subnational budget officials were also under "dual subordination" to both federal and subnational authorities.

During virtually this entire early period, the federal government retained the power that it had in the old regime to "regulate" the rate of at least one of the major taxes and therefore the power to reduce funding to those oblasts with large tax bases and to increase funding to those oblasts with smaller tax bases.^{8,9} Transfers took the form of negotiated "subventions" in 1992-93 and they were utilized when the other two sources of revenue were not enough to cover a negotiated "minimum required expenditure budget."¹⁰

⁶ Subnational governments, properly speaking, do not receive revenues from service fees. Service fees are retained by the spending agencies that earned them; at least formally, they are not sources of budget revenues.

⁷ These were granted in 1992 by the *Law on the Rights of Local Self-Government* and the *Law on Basic Principles of the Budget System and the Budgetary Process* and in 1993 by the *Law on Budgetary Rights*.

⁸ The exception was a short-lived tax sharing assignment in June 1992 when all regions got identical sharing rates for all taxes.

⁹ In 1993 the regulating tax was the VAT.

¹⁰ Through the entire Soviet period, tax sharing rates for the major taxes were kept low enough so that most regions got an annual subvention from the federal budget. In 1992 and 1993, tax sharing rates were increased to the point that fewer oblasts required a general subvention from the federal government. But, in 1993 alone, sharing rates were changed three times.

At the local level, rayons and cities had the same general structure of funding sources as the regions, but revenue sharing and subventions were from their regional governments rather than from the federal government. Regional governments typically shared revenues with their local governments in very similar ways, replicating the relation between the federal and regional governments. Each local government usually had its own customized sharing rate for at least one major tax with revenues shared between the region and local governments. This “regulating” principle in tax sharing had appeal because it gave the upper level government the ability to redistribute funds to poorer jurisdictions which had smaller tax bases. But the ability to “regulate” revenues in this fashion came at the cost of destroying lower level government budget autonomy and introducing perverse fiscal incentives. In particular, the upper level government could always recapture or “claw back” the previous year’s budget surplus of local governments or offset any increase in local revenues (coming from a higher local tax effort) simply by reducing the sharing rate of the regulating taxes. In fact, this was a common occurrence.

The period 1992-93 is also characterized by the enactment of a series of general laws regulating fiscal issues and served as the backdrop for the drafting of the 1993 Constitution. Laws enacted in the early period of transition include the *Law on the Fundamental Principles of the Budgetary System and the Budgetary Process* of October 1991, the *Law on the Foundations of the Tax System in the Russian Federation* of December 1991, and the *Law on the Foundations of Budgetary Rights and Rights to Form and Use Extra-budgetary Funds* of April 1993. A prominent feature of these laws, in particular the *Foundations of the Tax System*, is that many of their provisions were ignored and unfulfilled (Wallich, 1994; Lavrov, 1998; and Igudin, 1998). While regional noncompliance with federal legislation was not unusual under the Soviet regime, the continued lack of compliance during the early years of transition converted some of these laws into mere proclamations. This created a precedent for the continued pattern of selective compliance by regions of federal laws.

Not long after the disintegration of the Soviet Union, some of the ethnic republics (most notably Sakha (Yakutia), Tatarstan and Bashkortostan) stopped tax remittances to Moscow and insisted on a “single channel” arrangement by which the regions would retain all tax collections and make one single negotiated payment to the federal government. Either because the federal government was absorbed in an intense fight between the presidency and the parliament or because it lacked effective means of enforcement, the most forceful response from the federal government to these demands was to make these regional governments responsible for all federal programs in the regions.

In summary, the 1992-1993 period was a continuation of the system inherited from the Soviet Union. Regional and local budgets were basically extensions of the federal government, and the system of intergovernmental relations was characterized by tightly centralized finances. Revenue sharing and intergovernmental transfers continued to be used as accounting tools to balance subnational budgets, whose size was determined nominally on the basis of expenditure norms but mostly by negotiation. There were only a few changes to the system during the early period. The single-most important change was the major shift in expenditure responsibilities from the federal to subnational governments, in part to bring more balance to the federal budget and also partially in an effort to discontinue the provision of subsidies and services that the public sector could no longer afford.

From the 1994 reforms to 1997

Important reforms in the system of intergovernmental fiscal relations took place in 1994. The budgetary autonomy of subnational governments was strengthened during this period and the federal government stopped the *ad hoc* offloading of expenditure responsibilities to regional and local governments that characterized the earlier period. However, the murkiness of the responsibilities of different levels of government continued and the federal government continued the practice of unfunded mandates to subnational governments. In revenue assignments, sharing rates for all major taxes shared between the federal government and regional governments were standardized across all regions and have remained virtually unchanged since then. To offset the discontinuation of regulated sharing rates, a formula-driven mechanism of equalization transfers was introduced in 1994. Subnational governments also experienced some increase in the level of revenue autonomy through federal legislation authorizing the introduction of new subnational taxes in the period from 1993 to 1996. Finally, subnational governments were also given discretion over the regional share of the enterprise profit tax by being allowed to lower the regional share of the tax anywhere from 22 percent to zero percent.

The reforms implemented around 1994 stopped short of introducing a transparent, stable and rational system of intergovernmental fiscal relations. In revenue assignments, the uniform revenue sharing arrangements were not always respected in practice by the regions and the power granted to subnational governments to introduce new taxes led to introduction of a myriad of small taxes creating significant economic distortions. At the same time, fundamental problems with revenue assignments were not addressed. For example, revenues from the VAT continued to be shared based on the region where the tax was paid (as opposed to the region where the productive value was added) while revenues from the EPT continued to be shared in the region where the firm's headquarters were located. The equalizing capacity of the new formula-driven transfer system was limited because of limited funding and because of fundamental problems with the equalization formula. A part of the new formula still tried to fill the "gap" between some measure of revenue collections and normative expenditure needs rather than equalizing differences in fiscal capacity and actual expenditure needs across the regions. The general dissatisfaction with the formula for equalization transfers caused legislators to increasingly subject the formula's results to political negotiations. The federal government never complemented the introduction of formula-driven equalization transfers with a system of categorical or conditional grants to pursue sectoral objectives. Instead the federal government maintained the *ad hoc* and non-transparent mechanism of "mutual settlements." These are non-budgeted and primarily negotiated funds which are only made public after budget execution. Similarly, the federal government has continued to use *ad hoc* budgetary loans to regional governments which are often not paid back.

The 1993 Constitution together with the reforms of 1994 appeared to have strengthened the position of the federal government vis-a-vis the regions and brought some order and stability to the system of intergovernmental relations. The signing of bilateral treaties, starting with the ethnic republics of Tatarstan, Sakha (Yakutia) and Bashkortostan, brought back some power to the regions, but in a more orderly

fashion that had been the case early in the transition. The combination of the 1994 reforms and the signing of the bilateral treaties was successful in bringing most dissenting regions into the system.¹¹

Also a characteristic of this period is that the reform efforts concentrated almost exclusively on the fiscal relations between the federal government and the regions. The regional governments were left on their own to structure their relationships with local governments (cities and rayons). For the most part, intra-regional fiscal relationships continued as they were in the earlier period, thus perpetuating the former Soviet approach.

The Reforms of 1997 and 1998

Starting in late 1997 and continuing in 1998, the government began to introduce a set of significant reforms before the ruble devaluation and financial crisis hit in August 1998. This was an expansive agenda for reform based on the draft *Tax Code*, the *Budget Code*, the *Law on Financial Foundations of Local Self-Governments* (approved in September 1997) and the *Concept of Reform of Intergovernmental Fiscal Relations in the Russian Federation*. The *Budget Code* addresses the reform of expenditure and budgeting issues, and the draft *Tax Code* addresses issues of revenue assignment. The *Concept of Reform* was drafted by an interagency working group led by the Ministry of Finance and formally approved by the government before the ruble crisis in August 1998. A significant feature of this reform agenda was a willingness by the federal government to structure to a greater extent the intra-regional systems of fiscal relations which until now had been left at the discretion of the regional governments. In particular, regional governments were required to on average meet some minimum sharing rates for the major taxes with local governments. The *Concept of Reform* also calls for an important change in the system of transfers. This reform agenda is ambitious but also somewhat uncoordinated and incomplete; details of the reform proposals are reviewed in the chapters below.

I.3 The Role of Politics in the Decentralization Process

Politics have played a pervasive role in the design and workings of intergovernmental fiscal relations in Russia. However, observers have held widely different views on the impact that politics have had on the overall performance of the system. In one view, the failure of the political system to accommodate widely diverse economic and political interests in the regions has fed conflict and heightened the political and economic instability in Russia during the transition period (Polishchuk, 1996; Ordeshook, 1995). In a different view, the political system has effectively saved the Russian Federation from political disintegration by facilitating political solutions, such as awarding special fiscal status to regions, that convinced all regions (except Chechnya) not to pursue secession from the federation (Treisman, 1996 and 1998a,b and Freinkman et. al., 1998).

¹¹ Of course, the approach did not work for Chechnya.

Part of the cause of the conflict between the federal government and some of the regions in the Russian Federation has been identified as the failure of the State Duma to provide adequate representation for regional interests and by the fact that it has been left almost exclusively to the regional administrations (through the Federation Council) to represent those interests. The lack of adequate representation of regional interests in the State Duma has been explained by the fact that half of the 450 Duma deputies are elected from nation-wide party lists. It has also been alleged that deputies from poorer regions have been consistently “bought” by national forces controlling bigger purses of resources and interests (Polishchuk, 1996; Ordeshook, 1995).

Overall, three distinctive periods can be identified regarding how the political process has affected the substance of intergovernmental fiscal relations. These periods are (1) the pre-Constitution period (1992-1993), (2) post-Constitution policies (1993-1996), and (3) growing political concerns with the cost of the bilateral tax treaties (1997-1998). The correspondence in timing of these three political periods and the phases of development of the Russian system of intergovernmental relations (discussed in the Section I.2) underscores the pervasiveness of politics in determining the evolution of the intergovernmental relations in Russia.

The Pre-Constitution period (1992-93)

The pre-Constitution period (1992-93) was characterized by the openly confrontational political relations between the federal and regional governments. This period was also marked by open political defiance of the federal authorities outside of fiscal issues. It was common among ethnic republics to start political campaigns (so-called “sovereignty parades”) to gain special status recognized in signed agreements with the federal government.

During this period, the federal government unilaterally shifted expenditure responsibilities and mandates on subnational governments without, in the view of the regions, providing adequate additional funding. Regional governments responded with the threat and often the action of withholding tax revenues collected in their territories for the federal government. While at the start of 1992 just a few regions had stopped or greatly reduced remittances to the federal government,¹² by the end of 1992 there were similar problems with 20 regions and by 1993 this number had increased to 30 regions (Wallich, 1994). The collective power of the regions vis-a-vis the federal government was also evidenced by the effective rejection by the regions of the revenue assignments contained in the *Law on the Basic Principles of Taxation* of December 1991. Among other measures, this law provided an exclusive assignment of VAT, taxes on international trade and certain excises to the federal government, while assigning the personal income tax and enterprise profit tax to the regions.

¹² The regions that stopped or greatly reduced remittances to the federal government early in 1992 included the ethnic republics of Tatarstan, Chechnya, Sakha (Yakutia) and Bashkortostan.

Post-Constitution Policies (1993-1996)

The second period started with the federal government crackdown in 1993 directed at both the conservative Supreme Soviet and the dissenting regions, and the enactment of the new Constitution. The Constitution gave considerable powers to the federal executive vis-a-vis the parliament and the regions, but stopped well short of concretely defining powers and settling past disputes. The Constitution also gave the federal government the ability to arrive at a series of bilateral agreements with a large number of regions. While confrontations between the federal government and some regions continued to test the strength of the federation during this period, the nature of these confrontations appears to have shifted from centrifugal tensions toward a competition between regions for special recognition and accordance of an advantageous fiscal status.

During this second period several new features surfaced in the political arena. Confrontation of regional interests caused by the increasingly significant economic and fiscal regional disparities was heightened. While poorer regions favored higher federal taxes and more transfers, richer regions strongly opposed both. Although economic conflict is not particular to Russia, the Russian case is more troublesome because the conflicting economic and political interests can be directly identified with regional boundaries (Polishchuk, 1996).

In response to the continued pressure from many regions, a pattern of more organized and long-term oriented bargaining between the federal government and the regions developed. The federal government, empowered by the Constitution, entered into a series of bilateral treaties with the regions trying to balance regional objectives that conflicted with national interests. The regions, first based on ethnic claims and later simply on threats and demands, bargained for and obtained preferential fiscal treatments.¹³ At the same time demands from poorer regions emerged for increased regional redistribution and regions pressed the federal government to continue to fund a wide array of public goods and services that it had earlier sought to offload onto the regions.

These regional demands were met most clearly through the allocation of transfers to the regions. Lavrov (1995) and Treisman (1996, 1998a,b), among other researchers, have found that federal transfers have been more responsive to political pressures than to other objectives such as equalization and fairness across regions. The federal government seems to have used transfers quite systematically to appease opponents and dissenters in the regions. For example, it has been argued that those regions that gave Yeltsin or his supporters little support in elections or those regions that declared sovereignty early in the transition have tended to get larger transfers.

¹³ Preferential treatment has taken several forms, including preferential fiscal arrangements (as with the earlier agreements with Tatarstan, Bashkortostan, and Sakha), free economic zones (as in Ingushetia and Kaliningrad), or regional development programs (such as in Komi).

Growing Concerns with the Cost of Bilateral Agreements (1997-1998)

Although during the post-Constitution period inflation was contained by a restrictive monetary policy, the conflicting budget demands were resolved by the federal government running a deficit and borrowing first domestically and then internationally to finance the deficit. That was the political choice. High interest rates and short-term maturities ballooned the debt service requirements and ultimately led to the ruble devaluation and debt default in August 1998. Besides creating mounting budgetary pressures, the granting of special fiscal treatments to many regions has carried other costs. These include resentment among regions, compromising the objective of a unified national market, and creating the conditions for continued demands for special treatment by practically all regions, where the heads of the executive and the legislatures, now democratically elected, had little excuse not to pursue the narrow interests of their constituencies.

In the period from 1997-1998, however, political awareness was mounting at the federal level of the straightjacket that these bilateral agreements had put upon federal budget policy. These concerns largely coincided with the onset of the financial crisis of 1998 that culminated in the collapse of the ruble in August 1998. Recognition was given to the fact that these bilateral agreements are a contributing factor in the lackluster performance of federal tax collections, in addition to other factors such as the large number of tax holidays and exemptions granted by the Russian tax system in the earlier years of the transition. But undoing the damage from bilateral agreements is proving much more difficult than getting rid of tax holidays and exemptions. Bringing bilateral treaties in line with the general legislative framework should achieve, among other things, the application to all regions of standard sharing rates for the major taxes. It is unclear at this point whether and to what extent this goal has been accomplished. The main means of enforcement in the hands of the federal authorities is the withholding of FFSR equalization funds and other transfers. But, even if this enforcement tool gets used, there is a significant number of regions (including some of the most politically problematic) for which this tool will be largely ineffective, since these regions do not receive any equalization transfers and only modest amounts of mutual settlements.

1.4 Dimensions of Fiscal Decentralization in the Russian Federation

The remainder of the chapters provide an in-depth analysis of the various dimensions of the Russian system of intergovernmental fiscal relations. Each chapter contains the discussion of a particular dimension of fiscal decentralization in the Russian Federation. The assignment of expenditure responsibilities in the Russian Federation is discussed and analyzed in Chapter II. Next, the assignment of tax revenues and other revenue issues, including tax administration and financial administration are considered in Chapter III. Chapter IV presents the use of intergovernmental transfers in the Russian system. Chapter V addresses the topics of subnational borrowing and emergency fiscal controls. Finally, Chapter VI reviews the main issues in policy formulation faced by the Russian government in their efforts to reform their system of intergovernmental fiscal relations.

The exposition of the Russian system of intergovernmental fiscal relations in the following chapters is supported extensively by empirical analyses. Most of the data used for this purpose originates from the Ministry of Finance of the Russian Federation and exhibits problems common to transitional economies. The reliability of the fiscal data is particularly limited due to the heavy reliance in Russia on methods of government financing that are not reflected in reported budget figures (such as budget arrears), as well as the pervasive use of non-monetary fiscal transactions (for example, governments frequently engage in swaps in which budget arrears are settled with tax arrears).¹⁴ These shortcomings of the data need to be kept in mind when drawing conclusion based on the analyses below.

¹⁴ In addition to these data issues, the Russian ruble was “re-denominated” in January 1997: one “new” ruble was issued for every thousand “old” rubles. Unless otherwise mentioned, all amounts are stated in “old” rubles.

CHAPTER II EXPENDITURE RESPONSIBILITIES

To some extent the expenditure assignment prevailing in Russia today is the one inherited from the Soviet Union. Yet while during Soviet times lower-level governments had practically no discretion on expenditure decisions, during the transition period regional and local governments have been able to exercise considerable discretion in expenditure decisions. This chapter looks at the formal assignment of expenditure responsibilities as well as the actual distribution of expenditures during the years of economic transition. In addition, the performance of the system of expenditure assignments is appraised. This chapter concludes with a summary of pending policy issues in the area of expenditures assignments.

II.1 How Have Expenditures Been Assigned?

Several things should be considered when examining the assignment of expenditure responsibilities in Russia during the economic transition. First, how have the expenditure responsibilities been assigned (both legally and in practice) among the various levels of government ? Second, have there been any changes in the general expenditure pattern over time ? Third, what trends or patterns can be detected when looking at expenditures by main functional classification over the transition period.

Legislative Assignments of Expenditure Responsibilities

Neither the Constitution nor any other legislation has clearly defined the assignment of expenditure responsibilities in Russia. Until recently, the only explicit reference to the division of expenditure responsibilities between the federal and regional governments was in the 1993 Constitution (Articles 71 and 72). In the Constitution some responsibilities are exclusively assigned to the federal level while other responsibilities are assigned jointly to the federal and regional levels; there are no responsibilities specifically assigned to regional governments. Yet, these constitutional provisions are quite vague. No paramountcy is assigned in the Constitution in case of conflict between federal and regional policies in joint policy areas, nor is there any indication who is primarily responsible for the concurrent responsibilities listed in Article 72 of the Russian Constitution. The closest attempt to make a more explicit assignment of expenditure responsibilities is contained in the *Budget Code* which was approved by the State Duma in 1998, but which won't come into effect until January 1, 2000.¹⁵

¹⁵ These expenditure assignments are evaluated in Section II.3.

Although the Constitution states that either the federal or regional governments can delegate functions to local governments, the Constitution does not enumerate any direct responsibilities for local governments. To this effect, the *Law on General Principles of Organization of Local Self-Government in the Russian Federation* of August 1995 contains a list (Article 6) of local government expenditure responsibilities. This provision has been interpreted as stating that the federal and regional authorities have no direct competence in these areas of local responsibility (Igudin, 1998). The *de facto* assignment of expenditure responsibilities that has taken shape over the past six years bears little resemblance to those stated in the Constitution.

The *de facto* expenditure assignment that prevails in Russia today, outlined in Table 1, largely complies with the general principle that each level of government should be responsible for expenditures with different service areas: services affecting the entire nation, such as defense and national security, should be the responsibility of the federal government; services affecting many communities, such as tertiary hospitals, should be the responsibility of regional governments; and those affecting exclusively the residents of a community, such as sanitation, should be the responsibility of local governments.

As is obvious from Table 1, there are many areas in which two or even three levels of government share responsibilities. In principle, it is useful to distinguish in expenditure assignments between (a) the responsibility to fund expenditures, (b) the responsibility to regulate expenditure functions, and (c) the responsibility to implement expenditure programs. Although the federal government has issued extensive regulations and mandates that affect subnational government spending in Russia, the relevant legislation on expenditure assignments has not clearly differentiated between the responsibilities to fund, regulate and implement expenditure programs.

The major changes in expenditure assignments took place in 1992 and 1993 when the federal government shifted a wide array of responsibilities down to subnational governments.¹⁶ The responsibilities delegated to subnational governments included social welfare responsibilities for consumer subsidies, cash subsidies for vulnerable groups, welfare programs for pensioners and the disabled, family and child allowances and support for the homeless. Responsibilities for most kinds of subsidies were shifted down as well, including those for agriculture and transport. In addition, regional governments were made partially responsible for housing for the military. During the same period, the federal government also shifted down responsibilities for many types of investment in infrastructure. Previously, all investments were centralized in the central government planning agency (Gosplan). This massive reassignment of responsibilities at the beginning of the transition process had the double purpose of helping to bring the federal budget deficit under control and also to reduce or eliminate certain kinds of expenditures, especially subsidies. However, in practice the delegation of so many expenditure responsibilities to the subnational level created problems, as regional expenditures on other categories (especially social services) were crowded out.¹⁷ Although a

¹⁶ See Martinez-Vazquez (1994) and World Bank (1996).

¹⁷ See Titov (1997) and Freinkman and Titov (1994).

few of the responsibilities shifted to the subnational level in 1992-93 were eventually taken up again by the federal government, the bulk of these added responsibilities remain at the subnational level.

In 1994 responsibility for many law enforcement activities was transferred to regional governments (Titov, 1997). After 1994 the assignments of expenditure responsibilities have become more stable. Yet, in practice expenditure assignments in the Russian Federation have continued to evolve as many shared responsibilities have been adjusted in the annual budgets (Igudin, 1998). This has been especially true for the division of responsibilities between the regional and local governments, where many functions are shared between these two levels of government and the actual division of subnational responsibilities differs from region to region. The issuance of expenditure mandates by the federal government has also contributed to the redefinition of shared responsibilities after 1994. In addition, a lack of uniformity in expenditure assignments between the federal and regional governments is perpetuated because special arrangements were introduced in bilateral treaties between these two levels of government.¹⁸

Changes in Expenditure Patterns Over Time

Since the beginning of the transition, the amount of economic resources available to the public sector in real terms has dropped substantially. This has been the product of the government's disengagement from many aspects of economic activity, the implementation of fiscal policies and the fact that real GDP dropped by more than 40 percent during the early transition period. Even when measured as a percent of GDP, total government expenditures (excluding extra-budgetary funds) dropped from 51.9 percent of GDP in 1992 to 32.9 percent in 1997 (Table 2). But while federal government expenditures as percent of GDP dropped by more than 20 percentage points from 1992 to 1997, subnational government expenditures during the same period increased by 5 percentage points. As a percent of GDP, subnational expenditures peaked in 1994 at 18.2 percent.

During the transition years the subnational government share in total government expenditures increased significantly. Subnational governments represented 23.7 percent of government expenditures in 1992 and 52.0 percent in 1997 (Table 3). A large part of the decentralization of expenditures was a reflection of actual changes in the assignment of expenditure responsibilities in 1992-93. For example, in this period subnational government expenditures increased in part as a consequence of the divestiture of social expenditure responsibilities by state enterprises (which included housing, kindergartens, health clinics and other facilities), since many

¹⁸ Often it is part of the treaty agreement that the regional government takes over some or all responsibilities of the federal government in the region including expenditures in overall administration, education, and construction in exchange for allowing the regional government to keep a larger share of revenues

of these responsibilities were shifted to local governments.¹⁹ Taking over the responsibility for housing impacted local budgets significantly because of the increase in energy prices and the decision made by most regional governments not to implement full cost recovery policies for housing and public utilities.²⁰

Notwithstanding these changes, the overall decentralization of expenditures, as shown in Table 3, seems to have converged toward a level with approximately half of the expenditures going through the federal budget and the other half going through the subnational budgets. This same rule of half and half approximately has also applied to the shares of the regional and local budgets in the consolidated regional (or subnational) budgets. In all, these figures indicate that a high degree of decentralization has taken place in the Russian Federation. However, actual decentralization of expenditure responsibilities can not be inferred from this observed pattern of expenditure decentralization. Even though funds go through local budgets, in many cases it is still true that the decisions of substance are made by regional officials or determined by federal regulations and mandates. For example in education, federal authorities play very significant roles in setting educational policies, such as determining curricula or selecting textbooks. The degree of true discretion at the regional and local levels is a complex issue that requires close sectoral studies.

Expenditure Patterns by Main Functional Classification

The actual expenditure shares at each level of government for major expenditure categories, shown in Table 4, help illustrate several important points with regard to actual expenditure assignments. Although there are policy areas of exclusive assignment, such as defense, most functions are shared by different levels of government. Subnational governments represented over four-fifths of all expenditures in education and health in 1996-97. And most of these expenditures take place at the local level rather than the regional. For health services actual expenditure shares of the federal and subnational governments have remained practically the same over the entire 1992-1997 period. Among subnational governments there has been

¹⁹ There are no precise estimates of the additional fiscal burdens on subnational governments that followed from the divestiture of social responsibilities by enterprises (Martinez-Vazquez, 1993 and World Bank, 1996). In 1992 enterprises reported expenditures on social activities equivalent to 4.12 percent of GDP and 3.3 percent of GDP in 1994. The actual impact on subnational governments varied significantly because of different exposure to the problem. Those subnational governments that had the advantage under the Soviet Union of having state enterprises were more affected. Subnational budgets, on the other hand, were compensated with additional receipts from privatization of enterprises, partial compensation from the federal budget through mutual settlements, and increased tax collections. In particular, a local turnover tax at a rate of 1.5 percent was introduced in 1993 to help subnational governments fund the additional expenditures.

²⁰ Subnational governments have also periodically taken over federal government expenditures such as arrears in federal wages (for universities, the military, the State Tax Service and law enforcement agencies) when these arrears led to social tensions (Freinkman et. al., 1998).

a slight increase in the role of regional governments in health expenditures. The process has been quite different in education expenditures where the share of subnational governments grew from 66.2 percent in 1992 to 86.8 in 1997. Most of the expenditures on education, 67.5 percent in 1996, take place at the local government level.

The large shift in expenditure assignments in 1992-93 are reflected in the evolution over time of the subnational government shares in “national economy” and social protection. While the federal government represented 80.8 percent of all expenditures in “national economy” in 1992 reflecting a large involvement in pure market activities, by 1997 its share had been reduced to 24 percent. For more recent years, regions’ expenditures for “national economy” are concentrated in subsidies to industry and transportation while local governments’ are on housing subsidies and communal services.

In the case of social protection, the reversal has been less dramatic, but still pronounced. In the case of social protection, there have also been marked ups and downs.²¹ Subnational government’s share in total expenditures on social protection reached a high of 81.5 percent in 1995, from 28.2 percent in 1992. But for 1997, it was down to 58.7 percent.²²

On average the composition of regional consolidated (i.e., regional plus local) budgets has remained quite stable since 1994 (Table 5). The average share of a region’s consolidated budget spent on health ranged from 15.2 and 16.1 percent in the 1994-1997 period. For education, the average share in the consolidated regional budget increases slightly from 21.7 percent in 1992 to 24.4 percent in 1997. Both of these expenditures did not vary much across the regions’ consolidated budgets, as shown by the small coefficients of variation in Table 5. On average, the highest share of regional consolidated budgets has gone to the “national economy”, and although the variation across regions has tended to increase somewhat over time, the variation has remained relatively low. The most important component of “national economy” expenditures has been for housing and public utility subsidies. On average, during the 1994-1997 period regions spent more on subsidies for housing and public utilities than they spent on health services and just a little less than they spent on education. The importance of housing subsidies in subnational budgets remained relatively constant over time. Subsidies to agriculture have been the second most important expenditure item of “national economy” expenditures, but it decreased from 7.1 percent in 1994 to 4.9 percent in 1997. The higher coefficient of variation for this type of expenditure also reflects a wider variation in regional policies in this sector. The importance of expenditures on social protection in regional consolidated budgets did not change much during these years and has been relatively small on average, 7.9 percent in 1997.

²¹ Some of the changes in expenditure composition between the regions and local governments have been affected by the definition of “social protection.” See Lavrov et al. (1996).

²² Social protection expenditures in Table 4 do not include social security expenditures (pension, invalidity, health, and unemployment) which are managed separately by four extra-budgetary funds.

A general concern in Russia, and in the international community, has been the impact that additional expenditure responsibilities in the early years of the transition, unfunded expenditure mandates, and overall fiscal austerity may have had on the ability of subnational governments to provide basic social services in health, education and social support. An early formal response to these concerns was to grant special treatment to the social sector in the readjustment process. The Russian Government declared the social sectors-- education, health, and social protection -- as priority sectors for budgetary allocations in 1992 and 1993, meaning that these sectors were spared from the drastic budgetary cuts suffered by other sectors such as defense or the economic sphere. In addition, the *Law on Budgetary Process* gave many expenditure items in the social sectors “protected” status under budget sequestering.²³ Despite the protected status, casual evidence indicated that at the beginning of the transition there were significant real cuts in the social sectors.²⁴

However, after the difficulties of the initial years, funding for the social sectors at the subnational level did not plummet. Actually, real per capita expenditures at the subnational level peaked in 1994. Real expenditures per capita in education and health also peaked in 1994 (Table 6). From 1994 to 1997 both real expenditure in education and health fell. Stated as indices (where 1994=100), spending on education was down to 92.8 in 1997 while spending on health was down to 78.9. On the other hand, per capita real expenditures on social protection grew slightly over the period; the index for social protection expenditures (also normalized at 100 for 1994) stood at 106.7 in 1997.

Even though the composition of expenditures in the consolidated regional budget has not changed that much on average, the shares of regional and local governments in the consolidated budget show large variations across regions. These shares are studied in Lavrov et al. (1996) and Freinkman et. al. (1998). The degree of centralization of regional finances is markedly higher in those regions that are more dependent on federal transfers. There also appears to be a correlation between the degree of regional centralization and attitude toward market reforms; more decentralized regions are more likely to have adopted market reforms.

The Problem of Unfunded Mandates

Unfunded mandates, the imposition of expenditure requirements on subnational governments without adequate funding by the federal authorities, is one of the most vexing problems in the

²³ Sequestering is the reduction of expenditure budgets during the ongoing budget year in order to adjust for inadequate revenue collections.

²⁴ Approximately one-third of all kindergartens in Russia closed down from 1992-94. Existing infrastructure on health and education was not maintained and practically no new construction took place. The funds dedicated to supplies and operations, other than wages, were cut to a minimum or eliminated. Many schools around the country reported not having books and hospitals lacked basic supplies and medicines (Martinez-Vazquez, 1994).

intergovernmental budgetary relations in Russia at the present time. The general complaint by local and regional governments is that over the past six years additional expenditure burdens have been imposed on them by federal legislation without compensating increases in the funds they receive from the federal government. As a result, two specific problems are caused. First, federal mandates effectively restrict subnational budget autonomy by limiting the control that subnational authorities have over their budgets. Second, in the absence of federal compensation, subnational budgets are further strapped by federal strictures.

The history of unfunded mandates can be traced back to 1992 when, early in the transition process, the federal government shifted down expenditure responsibilities in many areas of social welfare to subnational governments. With hindsight, these shifts in expenditure responsibilities appear to have been motivated by a desire to decrease the federal deficit. While subnational governments may have an advantage in delivering these services efficiently, the redistributive nature of social welfare programs justifies their full funding by the federal budget. Among others, the reassignment of expenditure responsibilities that took place in the first period of the transition included cash subsidies for vulnerable groups, welfare programs for the disabled and pensioners, family and child allowances, support for the homeless, and general consumer subsidies for housing and public utilities. The federal government justified this delegation of responsibilities by arguing that the general funding scheme for subnational governments (i.e., the revenue sharing and transfers) took into account the additional costs of providing these additional services. The subnational governments disagreed (and continue to disagree) with this assessment and claim that the federal government has been imposing unfunded mandates on the regions in an effort to solve its own budgetary problems.

Awareness and discussions of the problem of unfunded mandates have increased in recent times in the Russian Federation, both because of increasing fiscal austerity at all levels of government as well as the seemingly increasing dimension of the problem. This has resulted in the outright prohibition of the practice of unfunded mandates. The *Law on the Financial Foundations of Local Self-Governments* of September 1997 prohibits regional governments from issuing unfunded mandates to local governments. The draft *Budget Code* currently under consideration would prohibit the use of unfunded mandates at any level of government. Despite the formal ban on the use of unfunded mandates, there is general skepticism that this legislation will be effective in ending the practice.

II.2 How Has the System Performed ?

The significance of fiscal disparities across regions has grown markedly during the transition years. The increasing differences in regional expenditure levels have been caused in large part by growing regional economic inequalities. Table 7 shows the evolution of gross regional product (GRP) in per capita terms from 1992 to 1996, the latest year for which data are available.²⁵

Increasing Fiscal Disparities Over Time

Horizontal imbalances or fiscal disparities among the regions grew sharply over the transition period. The disparities among the regions in per capita expenditures were always high in Russia, but they have grown more pronounced during the transition. As shown in Table 8, the coefficient of variation for per capita expenditures across the regions doubled during the period from 1992 to 1997. A different measure of horizontal imbalance, the dispersion between the maximum and minimum per capita expenditures also doubled in the 1992-1997 period. The best-off region in 1992 spent close to 12 times more in per capita expenditures than the worst-off region. In 1997 this gap had increased to over 22 times.²⁶

The fundamental driving force for these fiscal disparities is the fast growing economic inequalities across regions. Economic disparities among Russian regions were significant at the time of independence. Regional economic inequality was a conspicuous feature of the Soviet system. An additional factor in the increase of regional expenditure disparities could be increases in price variations across regions. Price levels should be expected to have become more dissimilar over time, as federal subsidies for transportation of goods to the northern regions have declined. High inter-regional price differences are also sustained by a lack of inter-regional market integration (Berkowitz and DeJong, 1998).

During the years of economic transition, the coefficient of variation for GRP grew from 0.87 in 1992 to 1.04 in 1996 and the difference between the poorest and richest region jumped from 31 times in 1992 to 41 times in 1996. The increase in regional inequality can largely be explained by the growing

²⁵ A measure of gross regional product (GRP) is computed by Goskomstat for most regions of the Russian Federation. Since the measure of GRP is not computed for any of the autonomous regions in the Russian Federation, data for these regions were imputed based on the assumption that these regions have the same level of tax effort as the region in which they are contained. Since some of the autonomous regions have relatively high per capita revenue collections, any analysis using this variable could be biased if the imputed data are a poor reflection of the actual levels of GRP.

²⁶ There have also been some variations across regions over time. For example, Kostroma's expenditures per capita increased by 90 percent in real terms between 1992 and 1996 while those in Tuva decreased by 56 percent in real terms in the same period (Freinkman et. al., 1998)

concentration of economic activity in just a small group of regions.²⁷ In 1994, the difference in product per capita was five-fold between the average product per capita in the lowest and highest quintiles of the regional distribution (after adjusting for the cost of living, the difference was still four-fold). Concentration of economic wealth is, of course, much more pronounced for certain types of economic activity. In terms of natural resources, most oil and gas production is concentrated in two autonomous okrugs (Khanty-Mansi and Yamalo-Nenets). About three-fourths of all metal production was concentrated in 10 regions in 1995. The level of concentration in fuel production was about the same. By individual regions, the City of Moscow received 20 percent of all income, but it represented only 7 percent of the population. With regard to income, distant second and third richest regions were Tyumen oblast (4.5 percent of all income; 1 percent of the population) and St. Petersburg (4.3 percent of all income; 3 percent of the population).

The increase in economic disparities has become more acute because many of the industrial-location decisions made under the Soviet Union were non-sustainable in a competitive market environment and because of the collapse of the military-industrial complex (Polishchuk, 1996). Although national GDP is today approximately half of what it was at the beginning of the transition, different regions experienced widely different performances reflecting the structural changes in the economy. Regions that had an export base (natural resources, metallurgic and chemical industries), or developed a service industry based on international trade and finance, have done relatively well. Foreign direct investment has been concentrated in a small number of regions, especially in Moscow. Regions with an agricultural base or with a heavy presence of military industry and other manufacturing have often done much worse (Sutherland and Hanson, 1996).

Has the Fiscal System Dampened Or Contributed To Fiscal Disparities?

The lack of market development and economic growth outside a few regions combined with a lack of labor mobility has brought an enhanced role for the public sector in addressing regional fiscal disparities. How well has the fiscal system performed during the transition? In general, the fiscal system, comprising the assignment of revenues and transfers of all kinds, has mostly helped to reduce disparities. Yet, the equalizing effect of the fiscal system as a whole has not been enough to keep up with the increasing disparities in revenue collections.

The impact of the fiscal system on fiscal disparities is illustrated in Table 9, which presents the coefficients of variation for the per capita amounts of regional resources allocated at several different stages of the fiscal system for the years 1992 through 1997. The first stage reflects collections of all revenues in the regions, including the federal share of joint taxes. At this first stage, the coefficient of variation is high and increases over time from 0.68 in 1993 to 1.61 in 1997. At the second stage of the allocation process, regional shared revenues (excluding the federal share), own source revenues and other regional revenues (before transfers) are considered. In general, this second stage shows a significant decrease in the

²⁷ See *Russian Economic Trends* (1997.2).

coefficient of variation compared to the first stage. For example, in 1997 the coefficient of variation decreased from 1.61 in the first stage to 1.39 in the second stage. Thus the system of revenue assignments has resulted in a more equal distribution of resources across the regions. The same can not always be said for equalization transfers and all other transfers (stages three and four). Based on the coefficient of variation, until 1995 transfers of all kinds tended to contribute to a more unequal distribution of fiscal resources across regions. However, at the end of the resource allocation process, we find that the coefficient of variation for the distribution of per capita expenditures (stage five in Table 9) is substantially lower than the distribution of all revenues collected in the regions (stage one) for 1995 through 1997. In the earlier years of the transition the reverse was true.²⁸

What drives the differences in subnational expenditure patterns? Regression analysis was used to explore the role of conventional determinants of variations in per capita expenditures across regions.²⁹ First, we considered the two conventional determinants of public expenditures: fiscal capacity (the ability to pay for government services, proxied by gross regional product) and the need for public services (proxied by several measures of socio-economic characteristics). In addition, we also consider a less conventional determinant, namely the level of tax effort exerted by a region (measured as the ratio of tax collections and fiscal capacity).³⁰ The ability to collect taxes in Russia may vary across regions because of the extent of the use of barter and underground economies and also because of subnational government fiscal policy decisions. From the experience of other countries, we would expect regions with greater fiscal capacity or greater expenditure needs to have higher expenditure levels. Also, regions who have an intrinsic higher demand for public services (as revealed by the level of collection effort) should have higher regional

²⁸ The equalization role of revenue assignments and transfers during the transition are discussed in more detail in Chapters III and IV.

²⁹ The dependent variables in the regressions presented in Tables 10-15 are per capita consolidated subnational (thus, regional plus local) expenditure levels. Because price levels differ substantially among the regions of the Russian Federation, a set of similar regressions was estimated using real per capita subnational expenditures (adjusted by cost of living) as the dependent variables. The results generated by this alternative set of regressions is virtually identical to those presented in Tables 10-15.

³⁰ The notion of higher tax effort in the Russian tax system does not carry the same exact connotation associated with the term in Western market-based economies. Subnational governments have limited scope for statutory discretion in tax collection: they have few taxes that they can levy, few rates they can change and few tax advantages that they can grant. What is different in Russia and other transitional economies is that despite the fact that the entire tax administration apparatus is a centralized function, the actual collection effort of the regional branches of the State Tax Service and the Tax Police varies significantly across regions and even across local governments. As discussed in the next chapter, tax administrators show *de facto* allegiance to subnational government interests which do not always coincide with those of the federal government.

expenditure levels.³¹ Descriptive statistics for the relevant socio-economic variables are presented in Table 10.

Using measures of fiscal capacity, need and effort, we are able to consistently explain over 90 percent of the variation in per capita subnational expenditures across regions from 1994 to 1997 (Table 11). Per capita expenditures have been higher in those regions with higher per capita GRP for all the years. The regression coefficients for per capita GRP are positive and significant for each of the years and becomes larger over time, an indication of the increasingly important role played by variations in the regional economic base or fiscal capacity in explaining regional public expenditures per capita. Per capita regional expenditures are also higher in those regions with higher expenditure needs, as measured by the cost of living and the presence of population that is either under or over the working age. These population groups are traditionally considered to have a greater need for government services, particularly in the areas of education and health care. These two types of expenditures are among the most important for subnational governments. The regression coefficients for these variables are positive and almost always statistically significant. A fourth proxy variable for expenditure needs, the percent of the population in the region that lives in poverty did not have any significant effect on the variation of expenditures per capita. Two possible explanations could be considered for this lack of significance; either truly no relationship exists between poverty levels and regional expenditures or poverty is not measured correctly. Last, those regions that received greater transfers as well as regions that exerted a higher tax effort also have experienced higher per capita expenditures.

Determinants of the Composition of Subnational Expenditures

Subnational government expenditures differ not only in level but also in composition. Regressions were again used to analyze the determinants of expenditure variations across the most important expenditure categories: “national economy” spending, education and health care (Tables 12-15). These regressions specifically focus on two questions. First, are expenditure levels for certain government functions influenced by the type of funding received? Second, what is the role of expenditure needs in explaining the variations in expenditures?

Several consistent patterns arise in the determinants of “national economy” spending, education and health care.³² The regressions explaining the variation across regions for expenditures on “national

³¹ A problem with introducing tax effort in an expenditure determination equation is that this variable may drive the results because of the identity relation between expenditures and revenues. These latter are used in defining tax effort. It could be argued therefore that tax effort should not be included in the current analysis. However, the results from the analysis remain essentially unchanged when tax effort is excluded from the regressions.

³² Understanding the determinants of expenditure composition is especially important for “national economy” spending. These expenditures are mostly suboptimal untargeted subsidies for housing and public utilities, which the federal authorities have unsuccessfully tried to eliminate.

economy” in Table 12 show that for 1994 through 1997 “national economy” spending tended to be higher in richer regions (with higher overall revenues), but also in regions that got more in equalization transfers and all other kinds of transfers.³³ Also significant is that those regions spending more on subsidies were also borrowing more and incurring higher budget deficits (“other sources of finance” in Table 12). Expenditure needs (measured by population under or over working age, cost of living, and the poverty rate) did not detract from the regions’ tendency to provide subsidies, except marginally in 1996 and 1997 when the coefficients for cost of living and population under working age were negative and statistically significant. The regressions explaining the variation of expenditures on subsidies to housing and public utilities (rather than all “national economy” expenditures) show the same basic patterns. The only difference is that regions with higher education expenditure needs, as measured by the percent of the population under working age, were less inclined to spend on housing subsidies (Table 13).

The regressions explaining the variation of expenditures on education (Table 14) and health (Table 15) also show some important patterns. Regions with higher revenues are able to spend more in education and health, but for each additional ruble in regional revenues the increase in expenditures here is substantially smaller than was the case for “national economy” expenditures. For the most part equalization transfer from the FFSR also lead to higher expenditures in education and health. Other forms of transfers do not induce significant changes in either education or health. This result coincides with the interpretation that mutual settlements address mostly issues on “national economy” expenditures. Several other patterns are revealing. In 1996 and 1997 regional governments appeared to have borrowed to increase their expenditure on education and health and those regions with higher poverty levels spent marginally less on education, at least in 1995 and 1997. At the same time, the regression analyses suggest that there is no systematic relationship between spending on education and health and the number of final consumers of the relevant services (i.e., children and seniors, respectively).

II.3 Pending Policy Issues in Expenditure Assignments

A government strategy for the reform intergovernmental fiscal relations has emerged with the “*Concept of Reform of Inter-Governmental Fiscal Relations*” drafted by the Working Group on Intergovernmental Fiscal Relations in 1998.³⁴ This document makes a fairly accurate assessment of the

³³ These results tend to coincide with those in previous research. Titov (1997) and Freinkman and Haney (1997) have tested different hypotheses on the determinants of the propensity by subnational governments to spend on subsidies (using expenditures on “national economy” as a proxy). Titov (1997) finds that these types of expenditures were closely related to regional GDP for 1992 but not so for 1994. Freinkman and Haney (1997) find that the propensity to spend more in subsidies decreases with regions that are economically depressed and increases in fiscally wealthier regions and in those that receive more in federal transfers.

³⁴ *Concept on Reform of Inter-Government Fiscal Relations in the Russian Federation in 1999-2001* (Annex to the Resolution of the Government of the Russian Federation no. 862, July 30, 1998).

current problems and proposes a strategy for comprehensive reform in intergovernmental fiscal relations. Earlier drafts of this document had focused almost exclusively on reforming the system of intergovernmental transfers and on emphasizing the need for a strategy to reform fiscal management at the subnational level. This section complements the analysis in the *Concept* reform document by highlighting areas in expenditure assignments which will require attention by policy makers in the immediate future.

Better Delineation Between the Public and Private Sectors

Although the extent of involvement of the different levels of government in strictly market activities has declined dramatically from socialist planned economy standards, there are still many activities, especially at the regional and local levels, that should be considered private economic activities. Subnational governments on average still spend 32.2 percent, or close to one-third of their budgets on general subsidies for private consumption or producer subsidies. There also has been a renewed impetus among subnational governments to become entrepreneurs of sorts to stimulate economic activity and employment. The constitutional mandate prohibiting the federal government from meddling with budget decisions of regional governments has made it difficult for federal authorities to promote expenditure rationalization in housing and public utility expenditures at the subnational level. The most effective approach is likely to be a program of conditional grants that requires participating subnational governments to reduce or eliminate these types of expenditures. This is essentially what is being proposed in the *Concept on Reform of Inter-Government Fiscal Relations*.

There Continues To Be a Lack of Explicit Assignment and Confusion in Expenditure Responsibilities

The Russian Federation still lacks an adequate assignment of expenditure responsibilities in the law. Clearly, a stable and transparent system of intergovernmental fiscal relations will require a well defined institutional framework with no ambiguity in order to resolve conflicts in the assignment of expenditure responsibilities among the different levels of government. The assignment of expenditure responsibilities in the *Budget Code* is more explicit and clearer than that in the 1993 Constitution (Table 16), but it still falls short of what is needed. Chapter 11 of the *Budget Code* identifies exclusive responsibilities for each level of government (federal, regional and local) and a number of responsibilities to be jointly provided by all three levels of government. However, there are some important responsibilities that are not clearly assigned. For example, education and health services are mentioned in the list of local responsibilities, but only in the context of those institutions owned by local governments. So there is no clear distinction of what types of education (primary, secondary and so on) and what types of activities within education (teachers, textbooks or curricula) should be the responsibility of local governments.³⁵ Neither does the *Budget Code* provide

³⁵ An example of such confusion is discussed in Bahl et al. (1998). Regional and local officials in Leningrad oblast disagree over the assignment of responsibility for teacher salaries. As a result, teachers in this region are annually faced with wage arrears.

any mechanism to resolve possible conflicts among levels of government for those functions that are jointly shared.

In fact, the assignments in the *Budget Code* are much less clear than the reality that has taken shape over the past years. The expenditure assignments in the *Budget Code* appear to be another exercise in legal ambiguity that has plagued Russian in the transition. The *Concept on Reform of Inter-Government Fiscal Relations* (1998) does not offer any solution either; it basically reproduces the expenditure assignments in the *Budget Code*. Both the *Concept* and the *Budget Code* require revision.

The proper starting point for introducing clarity in the assignment of expenditure responsibilities is with understanding the actual assignments of expenditure responsibilities that have been in place over the past years. An inventory of actual expenditure assignments ought to be conducted at different levels of detail.³⁶ The next step would be to examine which of the current *de facto* assignments are wrong or problematic (as discussed in the section directly below.) At a minimum, the clarification of the relations between the government of the Russian Federation and the subjects of the Federation will require establishing primary responsibility for the concurrent responsibilities listed in Article 72 of the Russian Constitution. Regions should be assigned primary responsibility for government functions that are traditionally administered by local or regional governments (such as local administration, law enforcement and elementary and secondary education) while the federal government should be assigned the primary responsibility for policy areas that are of national importance or redistributive in nature, such as civil rights and redistributive social policies. In addition, paramountcy should be established along the lines of primary responsibility to reinforce the separation of federal and regional activities. The assignment of primary responsibilities and paramountcy could either take place through the conventional legislative process or through the amendment of the Constitution of the Russian Federation.

Some Current Expenditure Assignments Should Be Reformed

There are no clear-cut rules for assigning expenditure responsibilities to different levels of government. Adequate assignments are reached typically as a compromise among often conflicting objectives pursued by decentralization policy. Several general principles, however, can help guide the design and reform of the assignment of expenditure responsibilities.

An *efficient* provision of government services requires that government satisfies the needs and preferences of taxpayers in the least-costly way possible. Because local governments are closer to taxpayers, efficiency can typically be increased by keeping the provision of services at the lowest level of government. This rationale is known as the “principle of subsidiarity.” Higher levels of government should be assigned expenditure responsibilities for those services with significant spillover benefits across smaller jurisdictions. It is likely that smaller governments will fail to adequately internalize those spillover benefits. Higher levels of government should be assigned expenditure responsibilities for those services with

³⁶ Lavrov (1998) recommends conducting an exhaustive survey of actual expenditure assignments as a preliminary step to reforming the expenditure assignment in the *Budget Code*.

significant economies of scale and scope. However, these production efficiencies may still be captured by smaller governments by contracting for services with either non-government enterprises or larger government units. The realization of efficiency gains in the allocation of expenditure responsibilities requires effective democratic representation, proper budgetary institutions, including local discretion to vary the composition of the budgets, and the ability to link costs of provision via fees, service charges, or local taxes.

Expenditures undertaken by government for *equity* or income equalization and for *macroeconomic stabilization* should generally be the responsibility of the federal government. Attempts by subnational jurisdictions to redistribute income can easily backfire if there is significant taxpayer mobility. More importantly, the incidence of the poor is likely to be higher in relatively poorer jurisdictions, which by themselves are less able to address the problem. Subnational governments may have an advantage in the implementation of redistributive programs but, with very few exceptions those programs should be financed at the national level. The larger dimension of macroeconomic problems and the open borders across subnational governments give a clear advantage to the national government in the area of macroeconomic stabilization. However, subnational governments can play an effective role in outlining and implementing regional development policies.

These general principles for assignment of expenditure responsibilities can help identify wrong assignments but they do not lead to a unique or optimal blueprint for expenditure assignments. Balancing the objectives of efficiency, equity, and macroeconomic stability can lead to quite different, but equally admissible, expenditure assignments.

Overall, most of the current (*de facto*) expenditure assignments in Russia do not violate the general principles of expenditure assignment. The current assignment could be maintained in many policy areas to the extent that they are clear to all parties involved. However, even in these areas a formal and explicit statement of responsibilities will eliminate (or at least reduce) the possibility of arbitrary re-assignments of expenditure functions and thus increase certainty and stability in intergovernmental fiscal relations.

Nevertheless, there are some expenditure areas in which the current (*de facto*) assignments should be reformed. The most important of these is social welfare. A major defect of the current arrangement in expenditure responsibilities is the failure to distinguish between financial responsibility and delivery or implementation responsibility. Financial responsibility for most public expenditures with a redistributive purpose should be allocated at the federal level. In Russia, those subnational governments that have the highest need in terms of social welfare are also the least capable of financing these programs. However, many of these regional and local governments still have a comparative advantage in delivering many of these welfare programs because of proximity to the population that requires these services. Of course, there are many types of locally financed expenditures that are redistributive in nature, such as school meals for poor children or shelter for the elderly poor, which have a legitimate place in local budgets. There are other areas that require reassignment of responsibilities. The current responsibilities of subnational governments for national defense, although small, should be completely reassigned to the federal level.

Based on a clearer division of responsibilities, the sharing rates for the main taxes and the system of transfers should be reevaluated so that shared taxes and transfers serve as an appropriate source of funding for those policy areas for which regions are given primary responsibility. Given the current budgetary constraints faced by the Russia Federation, the level of funding for regional governments will likely fall short from providing an ideal “minimum level” of government services. Nonetheless, it will be incumbent upon the regional governments to fulfill their constitutional responsibilities to the best of their ability with the available resources.

In the realm of regional public policy, the role of the government of the Russian Federation should be limited to setting national goals (like in Germany) or to serving as a facilitator to harmonize regional policies (as in Canada). However, since regions would have primary responsibility for regional policy issues, the federal government should be prevented from issuing unfunded mandates in these policy areas.

A much harder but also needed exercise would be the harmonization of the many laws, decrees, or departmental orders that impact and overlap with expenditure assignment issues. In particular, what should the role of federal agencies (for example, the federal Ministry of Education) and its departmental orders be vis-a-vis the role of regional and local governments in the delivery of public services (for example, primary and secondary education)? This work will require distinguishing between the need for the decentralization of regulatory powers, responsibility for financing, and responsibility for the delivery of the public services.

Resolving the Issue of Unfunded Mandates

The problem of unfunded mandates is not an exclusive problem to the Russian Federation. In fact, the issue of federal mandates is practically universal among federal countries. As the respective roles of federal and regional governments evolve over time in a federal system, the shared responsibility of governance often reveals areas where the assignment of jurisdictions is not well-defined. These ambiguities arise despite the fact that the assignment of expenditure responsibilities is generally contained in the constitutions of federal countries. For example, when federal authorities seek to set national standards for air and water pollution, it often becomes a point of contention whether the federal government’s mandate to protect the environment supersedes the regional government’s right to regulate its internal affairs without federal interference. Tensions between the various levels of government are naturally heightened if unfunded compliance costs are associated with the federal mandate.

Some degree of overlap or concurrence between federal and regional responsibilities is virtually unavoidable in any decentralized system of government. One way to avoid political stalemate when conflict arises in areas of shared expenditure responsibility is to establish (in the constitution or through legislation) whether federal policies preempt regional policies in the case of conflict between federal and regional legislation. One important example of this type of conflict is the occurrence of unfunded mandates. The dominance of one level of government over another is often referred to as paramourty. While the principle of paramourty can be invoked to solve conflicts regarding the assignment expenditure responsibilities and disputes over unfunded mandates, this solution is neither comprehensive nor necessarily

desirable. As the example regarding environmental policy demonstrates, the issue of federal mandates may arise even when government responsibilities are clearly and exclusively assigned to the different levels of government.

Boex and Martinez-Vazquez (1998b) review the policy responses to unfunded mandates in Canada, Germany and the United States. The experiences of these countries show a spectrum of policy alternatives from which to formulate a response on the issue of unfunded mandates. A number of valuable lessons for the Russian Federation can be drawn from the experiences in these countries:

Clarify the Assignment of Expenditure Responsibilities. As discussed above, the first (and perhaps most important) lesson from the review of practices in other countries is that the best way to avoid conflicts over unfunded mandates (and the federal division of powers in general) is to define the respective roles of the federal and regional governments as clearly as possible. While expenditure responsibilities are relatively clearly assigned in the constitutions of Canada and Germany,³⁷ the assignment of responsibilities is much less clear in the United States. While disputes over expenditure assignments and federal mandates occur relatively less frequently in either Canada or Germany, federal mandates in the United States are frequently at the center of legal disputes between states and federal authorities.

Prohibit New Unfunded Mandates to Prevent Offloading. For budgeting purposes, the policy areas for which the regional governments are solely or primarily responsible should be considered to lie outside the area of federal jurisdiction. Consequently, unfunded federal mandates in these areas should be prohibited by law (as proposed in the new *Budget Code*) to avoid “offloading” of federal responsibilities to the regions without corresponding funding.

Prohibiting unfunded mandates seems to offer a simple and clean solution to the issue of unfunded mandates. However, when taken to an extreme this approach also presents problems. There are some mandates, even unfunded, that may be quite acceptable to subnational governments. For example, mandates that ensure civil rights, voting rights, and generally equal access and opportunity to citizens clearly serve the national interest and are examples of “good” mandates. In practice, accountability mandates (such as reporting requirements for judicial and financial administration of regional and local governments) are also good mandates that are rarely resisted in other countries, even though sufficient funding frequently is not provided for the mandate.

³⁷ Within the structure of the German federation, responsibility for virtually all policy areas is assigned to the federal government while largely limiting the role of the regional governments (Länder) to administering these policies in accordance with regional customs. The German federal government is under no obligation to provide funds to regions when imposing new mandates. In contrast, in the Canadian federal system the prohibition on unfunded mandates is implicit in the clearly delineated (and more balanced) assignment of government responsibilities between the federal government and the provinces (regions). In the United States, the U.S. Constitution does enumerate the jurisdiction of the U.S. federal government. However, courts have been willing to interpret these powers broadly despite the Tenth Amendment to the U.S. Constitution which assigns any powers not delegated to the U.S. government “to the States respectively, or to the people.”

In addition to the conceptual shortcomings of this approach, strict prohibition of all unfunded mandates would also cause practical problems. Most importantly, such blanket legislation could result in an administrative nightmare. A review of state mandates in the United States reveals that reimbursement programs for mandates are administratively complicated, politically controversial, enormously expensive, and often do not work.³⁸ In addition, there is a need to be realistic about the enforceability of a blanket prohibition of unfunded mandates. Outright prohibition of unfunded mandates could be circumvented by the legislature, as legislators in many countries have traditionally shown a great degree of creativity to circumvent unfunded mandate statutes. However, a legislative ceiling could be set on the cost that can be imposed on the regions by federal policies before an mandate statute is triggered. At the very least, this will ensure that federal policies will be closely scrutinized as to whether they will impose an excessive burden on regional governments.

Identify and Resolve Existing Unfunded Mandates. Unfunded mandates are an existing problem for subnational governments in the Russian Federation. A significant number of laws currently on the books mandate subnational governments to provide social service according to federally established “norms,” such as cash assistance levels. At the same time, subnational governments are not provided with any additional funding to cover these expenses. The first step in effectively dealing with existing unfunded mandates is to identify which federal programs, based on the clarified assignment of expenditure responsibilities, actually contain provisions that impose unfunded mandates.

A possible way to identify existing unfunded mandates is through the establishment of a joint committee drawing from the Federation Council, the State Duma, the Ministry of Finance and possibly representatives from regional and local governments, to carefully review the federal programs that are identified by subnational governments as imposing the greatest budgetary burdens. This joint review would determine whether a program should be considered an unfunded mandate based on the clarified assignment of expenditure responsibilities. When the joint committee identifies an unfunded mandate, it should evaluate the size of the burden imposed by the mandate and make a policy recommendation to either eliminate, fund, or modify the government program.³⁹

When existing legislation is identified to contain an unfunded mandate, the government will have several options how to deal with these government programs. One solution to the existing problem is to repeal these laws or modify them to give regions much greater flexibility in addressing the relevant policy

³⁸See Kelly (1995) for a review of reimbursement problems with reimbursement problems in the United States.

³⁹ Recent reforms in the U.S. approach towards unfunded mandates may serve as a frame of reference for the needed reforms in Russia. As part of the review of federal mandates in the United States required by the Unfunded Mandate Reform Act (UMRA) of 1995, the U.S. Advisory Commission on Intergovernmental Relations (1996) developed two sets of criteria to evaluate policy proposals. The first set of criteria was defined for the purpose of selecting mandates that are of significant concern to state and local governments. A second set of criteria was developed to develop policy recommendations for the reviewed mandates. While these criteria were specifically developed for application in the U.S. federal system, their applicability easily extends to other federal systems.

issues. It should be considered quite unlikely that the State Duma will repeal these laws, in light of the fact that it initially tried to devolve these expenditures responsibilities in order to reduce the federal budget deficit. At the same time, requiring subnational governments to fund these federal programs from regional funds (own revenues, revenue sharing and equalization transfers) would be prohibited under the new *Budget Code*.

To the extent that the legislature is unwilling to repeal federal laws that impose unfunded mandates, the government (through the Ministry of Finance) should initiate the development of a system of targeted or specific grants to fund the delivery of services at the regional level that are mandated by federal law. This approach forces the State Duma to assume financial responsibility for the federal programs it adopts and to be realistic about the cost of such programs. By impairing the State Duma's ability to offload its financial obligations on the regions, such a system of targeted transfers would force the legislature to take both the benefits as well as the costs into account when establishing policy priorities.

Increase the Power of the Federation Council as a Watchdog. The Russian political system already incorporates a powerful safeguard against the excessive use of unfunded mandates through the Federation Council, which consists of representatives of the subjects of the Federation. The Federation Council has the ability to block federal legislation containing unfunded mandates, although its decisions may be overruled by a two-third majority of the State Duma. In practice, this corresponds to requiring a legislative super-majority before an unfunded mandate can be passed. One possible option, although this would require a constitution amendment, is to require an even greater majority vote from the State Duma to pass legislation that has been identified as imposing an unfunded mandate. Again, this would require a mechanism to identify this type of legislation. The current U.S. practice of having the Congressional Budget Office evaluate each legislative proposal and apply objective criteria to determine whether legislation contains unfunded mandates could serve as a helpful example in this respect.

Increase the Cooperation Between Federal and Subnational Authorities. As a final suggestion, a solution to resolve intergovernmental tensions in a federal country is to establish a working partnership between the various levels of government. Functionally, the system of intergovernmental fiscal relations in Russia lacks an underlying framework of trust and basic cooperation between the federal government and the regional governments. Efforts should be made to establish more constructive and cooperative relations. In a cooperative atmosphere, federal and regional governments are more likely to jointly develop creative solutions to the problem of unfunded mandates. Intergovernmental cooperation in working groups and advisory councils fosters greater understanding between the federal and regional governments. Increased communication also allows regional governments to identify federal mandates that have outlived their usefulness or need updating, and enables regional governments to present the federal legislature with a set of recommendations for reform or repeal.

In the German system, an important safeguard against the over-use of unfunded federal mandates is the consensus-oriented approach to politics. The federal government consults extensively with the regional governments through a variety of councils and carefully evaluates the impact on horizontal and vertical equity of federal policy proposals. Similar cooperation is evident in most other federal countries. For example, in Australia a *National Fiscal Outlook* is prepared on an annual basis by a working group

of the federal Treasury (equivalent to a Ministry of Finance) and regional treasuries. This document presents medium-term projections of federal and regional government finances and serves as background information for the annual Premiers' Conference, a meeting between the Australian Prime Minister and the Premiers of Australia's states and territories. The Conference presents an opportunity for the heads of the federal and regional governments to negotiate about the allocation of public resources between the different levels of government, discuss the general direction of the national economy and address other issues concerning intergovernmental fiscal relations in Australia. Another component of intergovernmental interaction in Australia is the Loan Council, which comprises the federal Treasurer as chairperson and his counterparts from the states and territories. The Council coordinates public sector borrowing by the federal and regional governments.

CHAPTER III

REVENUE ASSIGNMENTS AND TAX ADMINISTRATION ISSUES

To a large extent the question of revenue assignments in the Russian Federation has been limited to a question of revenue sharing arrangements between the federal and subnational governments for the major taxes (value-added tax, enterprise profit tax, personal income tax, and excises). The history of revenue sharing arrangements for 1992 to 1997 is summarized in Table 17 for the major taxes. While revenue sharing remains the dominant source of revenues for most regional governments, over time regional and local own taxes have become an increasingly important source of subnational revenues during the transition.

This chapter reviews the most important issues on the assignment of revenues among the different levels of government in Russia. This review includes an analysis of the trends in revenue collections and a discussion of pending reform issues in the realm of revenue assignments. In addition, this chapter addresses a number of issues related to the collection of revenues in Russia, including the role of incentives and the structure of tax administration.

III.1 How Have Revenues Been Assigned?

The main dichotomy in revenue assignments in the Russian Federation has been between “shared revenues” (the sharing of revenues from the four major federal taxes between the federal government and the regions using temporary sharing rates) and other revenue sources, including subnational or “own source” revenues.⁴⁰ Subnational (regional and local) taxes in the Russian context during the transition should be understood as those taxes whose collections are “permanently” assigned (in full or in part) to regional and local governments. Properly speaking these are not own subnational government taxes since these governments have little or no discretion over the rates or bases for the vast majority of these taxes. Nonetheless, these “own source” revenues form an increasingly important source of subnational revenues and may be seen as functioning as the predecessors for truly regional and local taxes as these governments are slowly given more control over these revenue sources.

⁴⁰ The four major shared revenue sources comprise the value-added tax (VAT), the enterprise profit tax (EPT), the personal income tax (PIT) and excise revenues. For the analysis and discussion in this chapter, these revenues are consistently referred to as shared revenues. All other revenues that accrue to regional or local governments are herein generally referred to as own source revenues. However, this classification is not absolute; there are many ways to classify revenue sources in the Russian tax system. For example, in some cases the subnational share of the EPT has been characterized as own source revenue, since regions have been given influence over both the tax base (through exemptions) and the regional share of the EPT tax rate.

In general terms, three periods can be identified in the practice of revenue assignments since independence. Each of these periods is characterized by a different approach to revenue sharing and policy toward tax autonomy by subnational governments. Although on the whole revenue assignment practices have improved over the years, Russia still falls short of having developed an adequate system of revenue assignment.

Revenue Assignments in the Early Years of the Transition

During 1993, the value-added tax (VAT) and in some cases other major taxes, such as the enterprise profit tax (EPT) and excises, were shared between the federal government and the regions at variable sharing rates and on a derivation basis (i.e., the regional share was assigned to the region in which the revenues were collected or derived). Besides these revenues, some minor taxes were allocated 100 percent to subnational governments. In the terminology of the former Soviet Union, the sharing rates of the most important taxes were “customized” or “regulated.” The reason for “regulating” or adjusting the sharing rates for each individual region was to provide the regional governments with just enough revenues to finance the “minimum expenditure budget,” which was negotiated with the Ministry of Finance. Forecasted own revenues for subnational governments were subtracted from the minimum expenditure budgets to arrive at the gap that would have to be financed with revenue sharing. Although considerable debate and bargaining went on between the Ministry of Finance and the regional governments on sharing rates for particular taxes, these sharing rates were of less importance than the estimated financing gap; the gap would have to be covered with one tax or another. In poorer regions where overall revenue collections were low, the budget gap remaining after own source revenues and revenue sharing was covered by “subventions” or lump-sum transfers from the federal budget. The funding of local government budgets by regional governments followed exactly the same process as funding of regional budgets by the federal budget.

Two general points need to be added to the description of revenue assignments during the early transition period. First, the system of revenue assignments during this period evolved on a spontaneous basis and was in open contradiction with the law. In late 1991, the *Law on the Basic Principles of Taxation* had come into effect assigning the value-added tax (VAT), customs duties, excises and taxes on financial institutions as 100 percent federal taxes not to be shared with any other level of government. The *Basic Principles* assigned the personal income tax (PIT) and the EPT to federal government as regulating taxes, by means of which the federal government could regulate the flow of revenues to subnational budgets. The *Basic Principles* further assigned 21 minor taxes to subnational governments, and, more importantly, prohibited the introduction of any other tax not listed.

The provisions on revenue sharing of the *Law on the Basic Principles* were never implemented. The federal government was not able to overcome the opposition of the regions, especially the opposition to not sharing collections from the VAT. Second, the general rules did not apply to all regions. In 1992 Tatarstan, Bashkortostan, Yakutia (Sakha) illegally declared fiscal sovereignty and were able to benefit

from a “single channel” regime, whereby the regional government retained all tax collections in the region and negotiated a single payment with the federal authorities.⁴¹

The revenue assignments during 1992-93 presented several important problems. In the first place, there was a lack of revenue autonomy for subnational governments. This denied the system of intergovernmental fiscal relations the efficiency gains associated with ability of subnational governments to increase or decrease at the margin the funds available for the provision of regional public services. The sharing of some taxes with subnational governments, in particular the VAT (which was shared on a derivation basis), was very problematic. While enterprises operating in more than one region got the VAT credited and debited in different regions, there was no mechanism to sort out these flows among the regions. The enterprise profit tax was paid in the region where the business was registered and not apportioned among different regions according to any criteria of economic activity.

Perhaps more important is that the bargained approach to revenue assignments employed during the 1992-93 period created perverse incentives for the regions. In particular, subnational governments did not have any incentive to increase tax collections, either through subnational taxes or better enforcement of shared taxes with the federal government. The budget funding mechanism was openly defined in a way that any increase in tax effort by the regions would be offset by a reduction in the “regulated” sharing rates, subventions or transfers. The Ministry of Finance had several ways to claw back any additional revenues and from all appearances it seems to have used them. Issues regarding incentives and tax administration are discussed in greater detail later on in this chapter.

Due to the perverse incentives caused by this approach to revenue assignments, extra-budgetary funds came to play a much more significant role in the subnational government finances during this period since these were the only means to hide additional resources from the Ministry of Finance during negotiations on minimum budgets for the purpose of increasing overall funding levels. The same perverse incentives, of course, applied to local governments. They had no incentive to collect additional revenues because any gains would get clawed back by the regional governments.

Since the regulated sharing rates were subject to annual changes, the uncertainty regarding the overall level of funding also robbed subnational governments of any possibility for rational expenditure planning over time. To address this problem, the *Law on Budgetary Rights* of April 1993 required that the federal government assign to subnational governments full or strictly fixed shares for at least five years for the major taxes, with the exception of VAT. This requirement was only partially respected in future years.

⁴¹ Chechnya never paid any taxes. Many other regions, up to 24, were at least partially retaining additional taxes in 1993. Others, such as Ingushetia, have been practically exempt from paying taxes because they were declared free trade zones.

The Reform of Revenue Assignments since 1994

An important feature of the reforms that took place in 1994 is that the revenue sharing rates for the major taxes were standardized across regions. As shown in Table 17, these tax sharing arrangements have remained practically unchanged since then. In addition, subnational governments gained some measure of revenue autonomy during this period.

Major Shared Revenue Sources. The stability of sharing rates was formally set in the 1994 federal budget law, which stated that the uniform sharing rates applicable that year would remain unchanged until 1998. The sharing rates for federal/subnational governments that have applied since 1994 include 0/100 for the PIT, 75/25 for the VAT, 37/63 for the EPT, 50/50 for excises on alcohol, 100/0 for excises on energy products and 0/100 for excises on domestic production.⁴² The only change in sharing rates in the period from 1994-1998 has been the assignment of 10 percent of the PIT to the federal level in 1995 and 1996. This was discontinued in 1997 with the PIT fully assigned again to the subnational level.⁴³ The draft budget for 1999 recommends an alternative arrangement in which a federal PIT is collected at a flat rate of three percent and a regional PIT is collected with a progressive rate structure for incomes exceeding Rb. 60,000.

The introduction of standard homogeneous sharing rates at the regional level in 1994 represented a notable achievement for the system of intergovernmental fiscal relations, but, of course sharing rates could no longer be used for equalizing purposes. This same year, a formula-driven system of equalization transfers was also introduced. (Transfers are reviewed in full in Chapter IV). In combination with the formula-driven equalization transfers, homogenous sharing rates created the conditions to eliminate the negative incentives against increasing collections by subnational governments that were present in the 1992-93 approach. In addition, stability was brought to the revenue assignments by keeping the standard sharing rates without change for several years, permitting regional governments to plan their expenditure budgets better.

However, the perverse incentives to reduce collections did not disappear completely. The federal government still left the door open for negotiation and bargaining with the regions through mutual settlements, which are unbudgeted and non-transparent forms of transfers. Through these transfers, the federal government had an avenue to continue to claw back some of the additional revenues raised by the subnational governments. Starting in 1994, the federal government also negotiated a series of bilateral

⁴² Accruing 100 percent to the federal budget are revenues from customs duties; the VAT on imports, precious metals and stones, hydrocarbons and excise goods; and license fees for alcohol production.

⁴³ The 10 percent retention of the PIT in 1995 and 1996 for the federal government was earmarked for distribution among regions (and on down to local governments) for maintenance of residential housing and social and cultural assets. One reason why this arrangement appears to have been discontinued in 1997 is that the funds returned to the regions were in most cases roughly equivalent to the funds they would have had if they had been able to retain the 10 percent of the PIT.

treaties with many regions. These treaties broke away from the standard sharing rules by allowing some of the regions to retain a higher share of revenues than specified in the standard sharing rates.

Although revenue assignments may have improved over this period because of the use of standard sharing rates, the administrative problems and inefficiencies in revenue assignments persisted. The VAT continued to be shared with regional governments on a collection basis without adjustments, the EPT was still shared by place of registration since a new apportionment formula based on payroll and property was hardly ever applied. Also the full or almost full assignment of the progressive PIT at the subnational level on a derivation basis reduced the redistributive and equalizing abilities of this tax.

Other (Own Source) Revenues. In this period, subnational governments gained some measure of revenue autonomy. A presidential decree⁴⁴ in 1993 lifted the prohibition for the introduction of new taxes at the subnational level which was included in the *Law on the Basic Principles*. Not surprisingly, this measure led to the introduction of all sorts of nuisance taxes and other whimsical fees, especially on enterprises. Some of these taxes were removed after taxpayers took legal action. The power for regions to introduce new taxes at the subnational level was revoked, again by presidential decree in 1996, to be effective January 1997.⁴⁵

Other changes in tax legislation during this period, and still in effect today, provided subnational governments with some degree of tax autonomy. This has contributed to some extent to the ability of subnational governments to exercise higher or lower tax effort. The most important of these changes gave regional governments the freedom under the EPT to apply a tax rate from 0 to 22 percent of the tax base.⁴⁶ Many regional governments have chosen to grant tax holidays and advantages to particular investors. Regional governments also at the present time can set the rates for the taxes on enterprise property and property of physical persons up to a federally-determined maximum. Following federal guidelines, they can also set the rate, and at times the base of other, often minor, taxes. These include the forest tax, water tax, ecological tax, the resort fee, the transport tax, regional license fees, and advertising tax. Local governments also have been free to introduce two turnover taxes on the sale of products; first, the Housing Maintenance Tax with a rate of up to 1.5 percent for housing and social service infrastructure divested by enterprises and, second, the Road Tax, at a rate of up to 2.5 percent. Local governments have also been free to introduce an education tax of up to 1 percent of the payroll of enterprises. Some other minor local taxes are available to local governments.

Regional-Local Fiscal Relations. Despite these changes in revenue assignments between the federal and regional governments, revenue assignments at the regional-local level for the most part continued to be what they were in 1992-93 and in the previous regime. In most regions, sharing rates between the

⁴⁴ Presidential Decree No. 2268 "On Forming Republican Budget and its Relationship to the Subject of the Russian Federation" of December 1993.

⁴⁵ Presidential Decree No. 1214 of August 1996.

⁴⁶ The federal rate of 13 percent cannot be modified by regional governments.

regional government and each local government continue to be negotiated and set every year.⁴⁷ Although most regions still use “regulating” sharing rates, revenue sharing practices vary by region.⁴⁸

Since local governments felt that they were completely at the mercy of regional governments, local governments lobbied the federal authorities for the introduction of federal legislation imposing minimum sharing standards from the regions to the local governments. Of course, most regional governors opposed this kind of restriction.⁴⁹ The *Law on the Financial Foundations of Local Self-Government* of September 1997 was a compromise between those two positions. This law mandates some minimum sharing rates with local governments, but only as an average for all local governments in the region.⁵⁰

The worst consequence of this state of affairs in the regional-local relations is the continued lack of incentives for local governments to raise their own revenues. Even though the *Law on the Financial Foundations of Local Self-Government* clearly prohibits the claw-back of local revenues, as did the earlier *Law on Fiscal Rights of Regional and Local Governments* in 1993, the fact is that regional governments systematically claw back increased local collections by reducing sharing rates and/or transfers in the next period (Zhuravskaya, 1998).

Upcoming Reforms Contained in the Draft Tax Code

Perhaps it is appropriate to speak of a third phase or period in revenue assignments, which will begin with implementation of the draft *Tax Code*. The general part of the draft *Tax Code*, which deals with tax administration issues and taxpayer rights and obligations and also with the assignment of taxes to different levels of government, was approved by the State Duma in 1998. The revenue assignments in the *Tax Code* are summarized in Table 18. All major taxes (VAT, PIT, EPT, and excises) are kept as federal taxes to be shared with subnational governments the same way it has been done in the past. Regional and

⁴⁷ Some regions did reform their budgetary relations with local governments along the lines of the federal-regional reforms of 1994 (Lavrov et al, 1996). For example, approximately ten regions in 1995 were using uniform sharing rates with local governments, but only two of these had a system of transfers based on formula (Sverdlovsk and Jewish Autonomous Region).

⁴⁸ See Igudin (1998) for some variations on how regions structure sharing rates with their local governments. Some regional governments have not changed their sharing rates with local governments for some years. Other regions use standard uniform sharing rates for rayons but “regulate” them for cities.

⁴⁹ In fact, the *Law on the Financial Foundations* was turned down by the Federation Council. Subsequently, the Duma introduced several changes and the amended legislation was approved by both the Duma and the Federation Council.

⁵⁰ These standards include 50 percent of PIT revenues, 5 percent of EPT, 10 percent of VAT, 5 percent for excise duties on alcohol, and 10 percent for excises on other goods.

local governments are assigned several new taxes and lose many of the old ones. But whether or not the new taxes will be implemented depends on the passage of the specific part of the draft *Tax Code*, found in the second part of the Code, which develops the structure of all taxes.

The second part of the Code has not been discussed beyond a first reading by the State Duma. Because of the political uncertainty that followed the devaluation of the ruble in August 1998, most of the taxes developed in the specific part of the *Tax Code* have yet to be discussed or approved by the State Duma as of June 1999. Two issues are especially noteworthy in the potential reform contained in the draft *Tax Code*.

First, in the draft *Tax Code* regional governments are provided with a significant potential increase in revenue autonomy. If the draft *Tax Code* is adopted, regional governments will be able to introduce a final sales tax up to a rate of 5 percent for general goods and up to 10 percent on excise goods. In actuality, a new regional sales tax with a maximum rate of 5 percent and with a narrower base than the regional sales tax outlined in the draft *Tax Code* was introduced in the second half of 1998 as part of the economic emergency measures precipitated by the ruble crisis. Unfortunately, the government is planning to partially substitute the VAT with the higher rate final sales tax, based on the erroneous belief that a retail sales tax would be easier to enforce and that it would bring more cash revenues than the VAT.⁵¹ It is quite clear that neither the sharing of federal VAT revenues nor a regional VAT are proper ways to achieve vertical balance between the federal and subnational governments or revenue autonomy for subnational governments.

Second, the draft *Tax Code* also provides for the introduction of a western style real estate property tax at the regional level, which is to be shared with local governments. The regions will have the choice of using the real estate property tax as a substitute for three existing property taxes (land tax, individual property tax, and tax on property of organizations) and will have some discretion on rates. The revenue potential of the real estate property tax is at this stage in question given the difficulties of setting up its proper administration. Two pilot cities (Novgorod and Tver) have been working on its introduction over the past three years, but it is not clear that they will not be ready to be introduced in 1999. It is more likely that only the city of Novgorod will implement the real estate property tax, but just on residential structures (land excluded).

III.2 Trends in Revenue Collections

While throughout the transition the bulk of subnational budgetary revenues has been in the form of revenue sharing and transfers, there has been a steady increase in the role of own-revenues in subnational government budgets. Subnational own source revenues represented just 16.7 percent of subnational

⁵¹ In December 1998, the government sent the State Duma a proposal to increase the regional sales tax rate to a maximum of 10 percent. As part of the same proposal, the general rate for the VAT would be reduced from 20 percent to 14 percent. The State Duma voted to postpone discussion of these proposals to a later date.

revenue collections in 1992. By 1997, this figure had increased to 40.5 percent (Table 19). This is a reflection of the increased revenue significance of the new taxes that subnational governments were able to introduce by presidential decree between 1994 and 1996, and also of the poor collection performance for the major shared taxes with the federal government.

Major Shared Revenue Sources

In the turbulent early years of the transition, not only were revenue shares regulated but there were multiple budgets in one year and the federal government offloaded numerous expenditure responsibilities to subnational governments. In this early period, the subnational governments' share of overall revenues jumped from 39.7 percent in 1992 to 54.4 percent in 1993 (Table 20). With the 1994 revenue sharing and transfers reforms, the subnational governments' share of overall revenues settled close to 50 percent and remained in this neighborhood through 1996. The figures available for 1997 show that the balance of revenue distribution moved up to 57.5 in favor of subnational governments.

The actual revenue sharing between the federal and subnational governments has always differed from the revenue sharing provisions stated in the annual federal budget law. This is evident from the comparison of the sharing rates as stated in the budget law, Table 17, and the actual shares of collections, as shown in Table 20. The lack of correspondence is apparent in most taxes, but is most pronounced for the VAT. There are several reasons for this lack of correspondence between statutory and actual sharing rates.⁵² First, regions in 1994 started unilaterally, and in later years were legally allowed, to withhold extra amounts of VAT collections in their territories in lieu of budgeted transfers.⁵³ Second, some regions simply refused total or partial remittance of tax collections to the federal government in the earlier years of the transition. In the later years, a number of regions have been allowed to keep larger shares of revenues on the basis of the bilateral treaties signed with the federal government. Third, tax arrears have accrued faster to the federal share than to the regional share of most taxes. Fourth, budget loans outstanding at the end of the year were offset against the transfers due to those regions in the following year.

The reasons for the different profiles for federal and regional tax arrears are also complex. First, as discussed elsewhere in this report, only a fraction of tax payments to the STS is in cash, mainly due to the pervasiveness of barter and other non-monetary forms of payments among Russian businesses. In this environment, regional governments have been more willing and able to accept tax payments in the form of offsets (canceling out of mutual debts between the government and taxpayers) and other non-monetary forms of payment. The greater rate of collection of the regional component of shared taxes may also be due to the fact that regional and local tax inspectorates still owe considerable allegiance to subnational bosses.

⁵² These issues are also discussed in Freinkman et. al. (1998) and World Bank (1996).

⁵³ Until recently, at least, Russia has lacked a developed treasury system that would allow the easy transfers of funds throughout the national territory. This issue is discussed more fully in Section III.5.

This can mean that regional and local tax offices may be trying harder to collect revenues accruing to subnational budgets or that cash-strapped businesses are allowed to clear subnational governments' tax arrears first.

Other (Own Source) Revenues

During the economic transition period, there has been a clear increase over time in the importance of own source revenue collections (as was shown in Table 19). As mentioned at the beginning of this chapter, own source revenues are broadly considered to be those revenue sources assigned (in whole or in part) to subnational governments, excluding the four major shared revenue sources.⁵⁴ The relative importance of the various subnational own revenue sources is explored in Table 21. The table enumerates the composition of consolidated subnational own source collections, revealing that over 80 percent of subnational own revenues comes from three revenue categories. Property taxes make up approximately 40 percent of subnational own source revenues, while natural resource taxes contribute roughly one quarter of own revenues. A local tax, the Housing and Militia Maintenance Tax, raises almost 20 percent of subnational own source revenues. The remaining regional and local taxes account for no more than 15 percent of own source tax revenues.

While the increased magnitude of these "own source revenues" is not disputed, it is often questioned whether these increases in subnational own source revenues have translated into real increases in revenue autonomy. Revenue autonomy requires that in addition to receiving the revenues from a tax, subnational governments have a substantial degree of discretion over either the tax base or rate. It is not uncommon in the Russian tax system that while the revenues from a tax are assigned to the regional or local level of government, the rates and bases of these own source taxes are actually determined or limited by federal law or federal authorities.

The degree to which regional and local government are able to exert control over their own revenue sources is explored in Table 22. The table lists which level of government legislated the main subnational taxes and who has control over the tax base and the tax rate. As can be seen, regional governments are able to set the rate of the enterprise property tax, albeit within federal limits, which accounts for virtually all property tax collections. Similarly, the Housing Maintenance Tax falls clearly within the purview of local governments. On the other hand, Table 22 shows that subnational governments have no control over either the tax base or the tax rate for revenues from natural resource taxes. It should be noted that all reviewed

⁵⁴ Unlike in the case of the Russian tax system, under international practices shared revenues are virtually never considered as own source revenues. Instead, the regional share of shared revenue sources are often considered transfers due to the general lack of influence by subnational governments over either the bases or the rates of these taxes.

taxes are federally legislated, thereby distancing regions from actively participating in the development of the tax system.⁵⁵

When the information contained in Table 21 and Table 22 is considered jointly, it is clear that regional and local governments have some degree of revenue autonomy. In particular, it is the subnational government's control over the rates of the enterprise property tax and the housing maintenance taxes that gives them a good degree of revenue autonomy. At the same time, federally-imposed limits on the tax rate place an upper-bound on the ability of subnational governments to be more responsive to their specific fiscal needs and wants. Greater revenue autonomy could be accorded not only by allowing regional and local governments increased input in determining the tax rates for federally legislated taxes, but by allowing regions greater freedom in legislating their own revenue sources and possibly allowing regions greater freedom over the administration of own source revenues. Discretion or autonomy in designing tax bases is less desirable because of the greater compliance costs this practice imposes on taxpayers operating in more than one jurisdiction.

III.3 How Has the System Performed?

The trends in revenue assignments have had an impact on the performance of the revenue system in a number of ways. First, compared to pre-transition levels, subnational revenues have increased as a share of GDP. Second, increased revenue autonomy at the subnational level has resulted in improvements in the vertical fiscal balance. Third, greater freedom at the subnational level combined with increases in regionaleconomic disparities has resulted in greater horizontal fiscal imbalances. Fourth, distinctive patterns have emerged in the distribution of public resources between regional and local governments.

Revenues as a Share of GDP

The share of overall subnational revenues in GDP has changed over the transition period albeit not drastically. This share was 13.8 percent of GDP in 1992. It peaked at 18.2 percent in 1994 and stood at 15.7 percent of GDP in 1997 (Table 23). The share of federal revenues in GDP has remained lower than for subnational governments after 1992. The share of federal revenues in GDP in 1997 was 12.4 percent. The combined share of revenues from both levels of governments (excluding extra-budgetary funds) was 32.6 percent in 1992 and 28.1 percent in 1997.

It is generally perceived in the Western press that poor revenue collections in Russia are a main cause of Russia's economic problems. Even though Russia's tax-to-GDP ratio is below the average for OECD countries, an often missed story is that Russia's share of taxes in GDP (excluding extra-budgetary

⁵⁵ However, during the period from 1993 to 1996, subnational government had been allowed by Presidential decree to introduce their own taxes.

funds) *exceeds* that of several OECD countries, including the Japan, Switzerland and the United States.⁵⁶

Because GDP actually decreased considerably over the transition, a more complete picture of the evolution of real tax revenues for subnational governments is shown in Table 24. In constant 1995 rubles, per capita revenues have declined steadily since 1992-93. The trend improved slightly in 1997, when real per capita revenue collections increased almost 10 percent. But even for 1997, real revenues per capita were still considerably lower than for 1994. The indices used in Table 24, normalized at 100 for 1994, show that the worst performance in revenue sources in real terms has been for the EPT, in which the index dropped from 147 in 1993 to 46.9 in 1997. This reflects not only the poor performance of the economy in general and profits in particular, but also the changes in the tax laws which narrowed the base of the EPT (allowing more deductions and eliminating excess-wage taxes). Probably also reflected are the tax incentives and holidays provided by regional governments to enterprises.⁵⁷ Although there are no stellar performers among the different sources of revenues, VAT and excises performed relatively better than the rest. This may help explain the continued strong opposition of subnational governments to reform revenue sharing arrangements, giving them a larger share of direct income taxes (EPT and PIT) and a smaller share, or no share, of the VAT.

Vertical Fiscal Imbalance Improved Over Time

Vertical balance exists when there is a broad correspondence between the expenditure responsibilities assigned to each level of government and the fiscal resources available to them to carry out those responsibilities. The most common source of vertical imbalance is the lack of revenue autonomy at the subnational level. There are several reasons for this type of vertical imbalance, including

- C the perceived need for the centralized administration of the most significant taxes;
- C the assignment of the most elastic sources of revenues to the central government (even though local governments are assigned responsibility for public services with a more elastic demand with respect to income);
- C fear of tax competition or mismanagement among local governments, or;
- C simply a reflection of the dominant political power of the central government.

⁵⁶ Russia's tax-to-GDP ratio equals 22.0 percent for 1997 (excluding non-tax revenues). According to the *OECD Revenue Statistics 1965-1996* (1997), the unweighted average of tax revenue to GDP ratios (excluding social security) for all OECD countries in 1993 was 28.5. Russia's tax ratio exceeds that of Turkey (18.9), Japan (19.3), Switzerland (20.8), the United States (21.0) and Spain (21.7).

⁵⁷ Recall that regional governments can reduce their share in the EPT by charging any rate between zero and 22 percent.

Revenue sharing and transfers are typically designed to redress this vertical imbalance. However, both political accountability and economic efficiency require that subnational governments have their own sources of revenues, meaning taxes and fees over which they have total or almost total control (Boadway and Shah 1994). An item of specific concern in Russia is that although subnational governments are increasingly relying on “own source revenues” to fund their budgets, subnational government control over these revenue sources is often only marginal. In many cases, the base and rate of these taxes is still determined by the federal government.

Conventionally, vertical fiscal imbalances have been measured in two different ways. The first is to look at the surplus or deficit position of each consolidated level of government, before borrowing but after all revenue sharing and transfers have been implemented. This measure tends to be biased toward central or federal government mismatch because in many countries, either by law or by practice, subnational governments operate more conservatively than the national government. In most countries, the central government is allowed to borrow quite freely to cover current operations. In contrast, local governments in many countries are only allowed to borrow for capital investment purposes, if at all. This measure of vertical imbalance is only meaningful under the assumption that deficits are not the result of mismanagement or waste, or in other words that governments at all levels attempt to provide the services under their responsibility in an efficient manner.

Over the transition period in Russia, the federal government has run large (albeit declining) budget deficits, while the consolidated subnational government budget has moved from a small surplus to a small deficit. These trends are discussed in greater detail in Chapter V. By this deficit measure, therefore, there has been a lack of vertical fiscal imbalance in Russia during the transition. However, these figures need to be interpreted carefully. Because of the inability of many regional and local governments to borrow to any significant amount especially early in the transition, the early surpluses and minor deficits of subnational governments may be more a reflection of the institutional constraints and the budgetary uncertainty of the past years than a sign of fiscal health. Early on, regional and local governments may have kept a cushion of resources in extrabudgetary accounts to cover unpostponable expenses; unexpected revenue shortfalls were particularly frequent due to economic instability, poor revenue forecasts and the fact that intergovernmental transfers were subject to budget sequestering. The increasing use of borrowing to finance budget deficits at the subnational level, once institutional and market constraints started to be removed, point at the need to use caution in the interpretation of subnational budget surpluses as a sign of the lack of vertical imbalance in Russia during the early transition.

A second way to measure vertical fiscal imbalance is to examine what share of subnational government expenditures is financed with sources of revenues under the control of regional and local governments. The coefficient for vertical imbalance is calculated as one minus the share of the subnational government expenditures that are financed from sources of revenues not controlled by the subnational government. There is disagreement on how exactly to define those revenue sources that are controlled by a higher level of government and therefore different versions of the coefficient are typically computed.⁵⁸

⁵⁸ These indices were developed by Hunter (1977).

Table 25 shows the computation of three different indices corresponding to three different definitions of vertical fiscal imbalance, depending on the revenue sources that are considered to be outside the control of subnational governments for 1997. The first definition considers all revenue sources assigned to regional and local governments (excluding shared revenues and transfers) as own source revenues. The second definition also considers revenues from tax sharing as potential own source revenues, and the third definition adds untied equalizing grants to own revenues and shared taxes.

By construction, the coefficients of vertical imbalance take values between zero and one, with values closer to zero indicating a larger vertical fiscal imbalance. The small values of the coefficient for the first definition (when shared revenues and transfers are not considered part of subnational own source revenues) indicates a significant degree of vertical imbalance. A more proper perspective is given when the coefficients of vertical imbalance for Russia are compared with those computed for a selected number of transitional and Western European countries (Table 26). When compared to these countries, Russia achieves a relatively high score, suggesting a degree of vertical balance quite similar, for example, to the level of vertical fiscal balance present in the German system. Again, these results need to be interpreted with caution because the comparison in Table 26 does not reveal the degree of discretion that subnational governments have over their “own revenue sources.” As mentioned earlier in this chapter, subnational governments in Russia have limited discretion in setting the rates or defining the base of regional and local taxes.

Horizontal Disparities in Regional Revenue Collections Have Increased Steadily

Similar to what we saw for per capita expenditures, disparities in per capita revenue collections among regions have increased steadily during the transition. As shown in Table 27, the coefficient of variation for revenue collections across regions (inclusive of the federal share for all revenues) increased by 136 percent from 1993 to 1997. The highest per capita regional revenue in 1993 was 30 times higher than the lowest. By 1997 this difference tripled to 90 times.

The main reason for these disparities has been the increasing concentration of economic activity in a small number of regions, as discussed in Chapter II. There is, of course a strong correlation between economic activity and tax bases and revenues. The five highest collection regions represented 40.9 percent of all revenue collections (including the federal share) in 1997, up from 33.7 percent in 1993 (Table 28). Similarly, the twenty highest collection regions represented 70.9 percent of all revenue collections in 1997. When federal shares are removed, as can be seen in Table 29, the degree of concentration decreases, albeit not by much. In 1997, the twenty highest collection regions (exclusive of the federal share) represented 67.3 percent of all subnational revenue collections.

A significant factor contributing to the marked horizontal imbalance in per capita revenue collections is the unevenness in the distribution of natural resources in the Russian Federation. Leaving aside excise taxes on oil products which are assigned 100 percent to the federal government, subnational revenues from taxes, fees and charges on natural resources represented on average only 7.7 percent of regional tax

revenues in 1997.⁵⁹ However, the unevenness in the distribution of natural resources means that these revenues are highly concentrated in a small number of regions. For 1997 the three richest regions in natural resources collected 46.9 percent of all regional revenues from taxes, fees and charges on natural resources; for the top five regions this percentage was 52.7.⁶⁰

Two factors have been at work that multiply the impact of differences in natural resource endowments on regional revenue disparities. First, the relative importance of natural resource taxes and fees in the regional budgets, on average, has been growing fast over the past four years. Second, there is a high correlation between regional collections from natural resources and gross regional product (GRP); the correlation coefficient was 0.95 in 1997 (Table 30). Note also that the correlation between natural resource collections and total regional collections is high as well (0.96 in 1997) and has been increasing over time. These correlations are a reflection of the fact that businesses involved in natural resource extraction also pay other taxes and that other economic activity (processing, transportation and so on) may be generated in regions with significant natural resources.

Another factor that may have contributed to the existing disparities among regional governments is the manner in which shared taxes are apportioned among subnational governments. The impact of revenue apportionment mechanisms is hard to quantify without detailed taxpayer information. But the fact that enterprises pay all their EPT in the region where they are registered, rather than in all regions where they have economic activity, has likely contributed to the concentration of collected revenues in fewer regions. More proper apportionment mechanisms would establish a correspondence between the location of the economic activity (for example, production) and the apportionment of the shared revenue (for example, the EPT). The lack of proper apportionment of the EPT has worked to the benefit of regional and national economic centers, especially the City of Moscow. The apportionment of VAT on a derivation basis probably also has contributed to the concentration of regional revenues. What is certain is that regional revenue disparities would have been reduced if VAT had been shared with the regions on a per capita basis, such as is done in Germany, or an estimated consumption expenditure basis, such as is done with the maritime provinces in Canada.⁶¹ The apportionment of PIT by place of work rather than the place of residence should also contribute at the margin to the concentration of tax revenues in neighboring regions with a more industrial economic base.

⁵⁹ These include subsoil charges for use of mineral deposits, mineral rehabilitation (prospecting) charges and other fees for use of natural resources.

⁶⁰ These are, in order of natural resource wealth: Khanty-Mansi, Yamalo-Nenets, Tyumen, Tatarstan and Yakutia (Sakha). The top three regions hold 2.2 percent of the population of the Russian Federation; the population share of the top five regions is 5.5 percent.

⁶¹ The arrangement between the federal government in Canada and the province of Quebec may show a good way to share the VAT between federal and regional authorities. But the administrative complexity of the procedure makes it not too relevant to Russia at the present time (McLure, 1998).

Distribution of revenues between regional and local governments.

The distribution of revenues between the regions and local governments varies significantly by type of tax (Table 20). Although there are significant variations among regions, the most centralized revenue sources at the regional-local level are the VAT and excises while the most decentralized are property taxes and the personal income tax. Less wealthy regions, which are more dependent on federal transfers, tend to exhibit a higher degree of decentralization. A trend that has developed over the last three years is for regional governments to retain a higher proportion of personal income taxes and compensate local governments with higher transfers (Lavrov et al., 1996). However, it should be remembered that revenue assignments within the regions continue to have very little significance given current budgetary practices. Since regional governments have discretion to change revenue sharing rules and the level of transfers in any way they wish at any time, it is not the composition of funding sources that matters, but the overall level of funding. The latter is often determined prior to any discussion on revenue assignments in negotiations between the regional and local governments.

III.4 The Role of Perverse Incentives and Soft Budget Constraints

A major failure in the framework of intergovernmental fiscal relations in Russia has been the failure of the system to provide the right incentives to subnational governments to increase their own revenue collections and rationalize their expenditures.⁶² During the early transition period (1992-1993) the bargained approach to expenditure levels, the regulating revenue sharing rates and the negotiated transfers failed to provide subnational governments either with a hard budget constraint or with an incentive to raise their own revenues and make a more efficient use of the available resources by rationalizing expenditures. The reforms of 1994, which have been in place through the present, took some significant steps toward the goal of imposing a hard budget constraint, but ultimately fell short of this goal. Both regional and local governments still have a powerful incentive to understate and hide their revenues in extra-budgetary funds.⁶³

Overall, several fiscal practices can be identified that cause perverse fiscal incentives. First, subnational governments have responded to incentives (resulting from the reliance on budget expenditure norms to measure regional expenditure needs) to maintain existing infrastructure capacity rather than rationalize their expenditures. As a result, regional and local governments have failed to exploit possible gains in efficiency by improving the mix of inputs and continue to have an incentive to hide funds from the regional authorities in extra-budgetary funds. Consequently, the reform of the system of intergovernmental

⁶² Ordeshook (1995) argues that many of the political problems in Russia during the transition originate in the inability of the entire institutional framework to recognize the significant role played by incentives.

⁶³ Although the importance of extra-budgetary funds may be on the decline at the subnational level, at present there exists no good measure of their importance (Kirkow, 1996; Freinkman et. al., 1998).

fiscal relations needs to explicitly recognize the crucial role incentives can play in mobilizing revenue sources and increasing the efficiency of public expenditures. This issue is addressed in greater detail in Section IV.2.

Second, poor design of intergovernmental transfers can also reduce the incentive for subnational governments to collect revenues. For example, equalization transfers in Russia are often provided to subnational governments in which own and shared revenues were not large enough to fund their minimum expenditure budgets. By using (current or base year) revenue collections as a proxy for fiscal capacity, this “gap-filling” approach assures that any reduction in local collections due to lower fiscal effort is offset (at least in part) by an increase in the level of transfers.

Perverse fiscal incentives are even more prominent among local governments, which in most regions still negotiate their budget allocations through bargaining and negotiations much the same as was done in the former Soviet Union. Local governments routinely see a large percentage of any additional revenues clawed back by regional governments. As a result, subnational governments are still more concerned with hiding their fiscal resources (in particular through all sorts of extra-budgetary funds) and bargaining for more assistance from the upper-level government than with increasing tax collections. It has also been argued that soft budget constraints have led to local governments spending more funds on subsidies to housing and communal services, transportation and agriculture subsidies and less funds on health and education.⁶⁴ Whether this in fact occurred is difficult to determine.

III.5 The Role of Tax Administration

A major difficulty that has plagued the implementation of the system of intergovernmental fiscal relations in Russia has been the inability of the federal government to exert effective control over the regional branches of the State Tax Service (STS). The lack of a functioning Treasury system during the transition has also been a significant impediment to the smooth functioning of revenue assignments.

Administrative Structure of the State Tax Service

The Russian Federation government has been struggling with a lack of regional compliance with federal tax legislation and its inability to enforce these laws. Such difficulties have been present from the beginning of the transition. For example, the revenue assignments provided in the *Law on the Foundations of the Tax System of the Russian Federation* of December 1991 never were implemented because of the opposition of regional governments. This only could have been accomplished because the regional and local offices of the federal STS took their orders from the regional authorities rather than the federal authorities.

There are historical reasons for these problems with the system of tax administration. Under the Soviet Union, the system of tax administration consisted of a network of tax divisions of local and regional

⁶⁴ See, for example, Freinkman et. al. (1998).

financial offices with subordination to local, republican, and federal authorities. With independence, the Russian Federation moved quickly to create a national tax administration system solely under federal authority. The strong motivation was to avoid the repetition of what had happened to the Soviet Union. The refusal of republican authorities to share revenue upwards with the central authorities had led, in practical terms, to the breakdown of the Soviet Union.

However, while shortly after the establishment of the Russian Federation the State Tax Service (STS) was legally made a federal agency,⁶⁵ in many ways the STS has remained a confederation of local and regional offices with officials responding to both federal and subnational authorities. This dual subordination is apparent in many different ways. Regional and local tax administration officials still look up to and take informal directives from subnational authorities and in many cases they receive housing, office space, and other logistical support from the subnational governments. This *de facto* dual subordination has had important implications on how and how much tax revenues get collected in the regions and how much is remitted to the federal government. In substance, the inverted system of collections has not changed from what it was under the Soviet Union. In certain cases, local and regional offices still remit collections to the center, creating the opportunity for some regional governments to withhold payments to the center. This problem is especially poignant for Tatarstan and Bashkortostan since these regions have a so-called single channel arrangement, allowing these regions retain all federal revenues and to settle the balance of all claims to the federal budget through a single payment. Making fiscal federalism work, in particular enforcing federal policies, requires the transformation of the STS into a true federal agency. There are many important pending issues in the reform of the tax administration system, but making it an agency that responds exclusively to federal authorities may be the most important one. So far, there has been no serious attempt to introduce policies that could address this issue, such as providing all compensation for tax administrators from the federal budget or rotating personnel geographically.

Many other structural issues remain to be addressed in tax administration in the Russian Federation. First, is there a need for regional and local government tax administrations given the new subnational taxes already introduced or planned in the draft *Tax Code*? Second, should the STS and the Tax Police be integrated as in many other countries? Third, should the STS be in charge of collections for social security contributions to the extra-budgetary funds? Fourth, what is the role of the STS with respect to the property tax? These issues need to be carefully evaluated by the Russian government, and some will require a long time to solve. In the interim, the best general approach may be to rely on the State Tax Service as much as possible for the assessment and collection of the new regional and local taxes (with the possible exception of the property tax). Given the current weakness of the tax administration and limited resources, it might be best to concentrate on improving the current tax administration at the federal level before attempting to create new tax administrations at the regional and local levels of government. This must be counter-balanced with the realization that the State Tax Service's primary mission is to raise revenues for the federal budget. Therefore, the assessment and collection of solely regional and local taxes will be of

⁶⁵ To underscore the federal nature of the STS, in 1998 the agency was renamed the Ministry of Taxation.

less importance, and potentially costly in terms of resources. In the longer term, it would be more effective to have local and regional tax administrations to administer their own taxes, respectively.

The Ministry of Taxation also needs to play a better role in fostering the development of transparent and fair intergovernmental relations between the federal and regional governments and between the regional and local governments. The current distrust between the federal and oblast-level governments is exacerbated by the inability of the tax service to collect the budgeted revenues for each level of government. An example of this distrust is evident in the practice of having taxpayers write separate checks for the federal and oblast governments for the enterprise profit tax. This “revenue-sharing” responsibility clearly should be transferred from the taxpayer to the State Tax Service. This simple, but significant, improvement in taxpayer services would require significant coordination and agreement between the federal and subnational governments.

The Lack of an Effective Treasury System

Until very recently, Russia lacked a developed treasury system that would allow the easy transfer of funds throughout the national territory. As a result, a powerful force in the design of the system of intergovernmental fiscal relations historically has been the objective of minimizing the occurrence of financial flows and counterflows, whereby some funds would be sent to Moscow (e.g., collected federal revenues) while other funds would flow to the regions for some other reason (e.g., equalization transfers). Even though this would be considered merely an accounting issue in many other countries, in Russia the existence of counterflows has taken on real significance and not just because of the lack of a developed national treasury function. The regional governments in Russia have developed a mistrust of the ability and willingness of the federal authorities to re-send funds to the regions once the funds get into the federal budget accounts. The poor record of the federal government on this account is discussed in greater detail in Chapter IV on transfers.

III.6 Pending Reform Agenda in Revenue Assignments

There is an extensive reform agenda pending in revenue assignments. This reform agenda pertains to both federal-regional relations and regional-local relations. In the federal-regional area a lot has been accomplished, but there are still some important issues that need addressing. These include:

- C revenue sharing issues and apportionment problems;
- C problems with own source revenues;
- C extent of revenue autonomy;
- C vertical balance.

Several ongoing reform blueprints, including those in the draft *Tax Code* and the *Concept of Reform of Inter-Government Fiscal Relations in the Russian Federation in 1999-2001*, so far have represented missed opportunities for squarely addressing these issues. The *Tax Code*, if implemented,

would help address the issue of revenue autonomy but probably not by enough. The *Concept*, on the other hand, is mainly silent on revenue assignment issues, other than recommending the use of stable sharing rates for a period of three years. At the regional-local level, the need for reform is even more dramatic since many regional governments still continue to use the old approach of bargaining budget levels and “regulating” taxes and transfers with local governments.

Revenue Sharing and Apportionment Issues

In purely technical terms, the VAT is one of the worst taxes to be shared with subnational governments based on the location where the tax is collected because a mismatch frequently arises between the VAT payment made in a region and the actual value added in that region. The crediting and debiting of the VAT in different regions makes the VAT absolutely unsuited for direct revenue sharing on the basis of payment location. Based on this argument, the VAT should be assigned 100 percent to the federal level.⁶⁶ But eliminating revenue sharing for the VAT will be politically difficult or even impossible. It actually was tried in 1991-92, in the *Law of Basic Principles of Taxation* yet regions did not comply with the law. The regions (and the Federation Council) see these shared revenues as their own revenues. As a result, a more appropriate alternative would be to share the VAT with the regions using a different apportionment mechanism. For example, the VAT could be shared among the regions on a per capita basis, or based on other simple formulas.⁶⁷

A second problem with revenue sharing is that a progressive PIT as is currently used in the Russian Federation (and as designed in the draft *Tax Code*) should not be assigned 100 percent at the subnational level. The purpose of progressive income taxation is to redistribute resources across the national territory. Given the large fiscal disparities between the regions, the current sharing arrangement accomplishes little of that.⁶⁸ A solution would be to keep the progressive PIT as a federal tax (with lower rates). Subnational governments would be granted the right to introduce a piggyback proportional income tax with minimum and maximum rates to be used at the discretion of the subnational governments with the same tax base as the federal PIT.

⁶⁶ The arrangement between the Canadian federal government and the province of Quebec may be the only example of a workable dual VAT between the national and subnational levels (Bird and Gendron, 1998; McLure 1998). This dual system requires a high level of tax administration performance, not existing in Russia at the present time.

⁶⁷ The case for non-standard sharing rates determined by formulas has been strongly made by Igudin (1998).

⁶⁸ For so far as incomes vary within each region (as opposed to between regions), some redistribution at the personal level is naturally achieved.

A third problem with shared revenues regards the apportionment of EPT revenues. An apportionment formula that allots EPT revenues based on the average of payroll and property that enterprises have in different regions already exists in the tax laws, and the draft *Tax Code* respects this formula.⁶⁹ The problem is, as already discussed, that the formula is not used except on rare occasions. Instead, enterprises pay all their taxes in the region where they are registered. The obvious solution to this problem is to require multi-regional enterprises to file tax returns in each of the regions where they operate. Clearly this would be viable only if the presently overwhelming filing requirements are simplified. As a result of the current apportionment problems, the EPT should not be considered a good basis for revenue sharing.

One last issue in revenue apportionment, we have seen, is that in many cases the personal income tax accrues to the “place of work” jurisdiction and not to the “place of residence.”⁷⁰ However, it is more likely that individual taxpayers consume and demand public services more in their place of residence than in their place of work. Internationally, regional income taxes are often based on the place of residence.

Revenue Assignment Issues

An important outstanding issue regarding own source revenues is whether taxes on natural resources should be assigned to the regions (as is currently the case) or whether these revenues should be reassigned to the federal level. Valid arguments can be made on the side of allowing regions to keep these revenues and on the side of turning them over to the federal government.⁷¹ The literature on this issue suggests that revenues from natural resource exploitation should generally flow to the federal budget, as a country’s natural resources are often considered to belong to the nation as a whole. Also, accrual of natural resources taxes at the regional level could result in gross regional inequities. At the same time, fees that compensate regions for the actual cost of exploiting natural resources should properly flow to the regions. The final arrangement for the sharing of these taxes will require a balance and national consensus between objectives involving economic efficiency and horizontal balance, on the one hand, and the rightful compensation to subnational governments for environmental damage and the exploitation of natural endowments on the other. The discussion of the draft *Tax Code* at the State Duma and its consideration

⁶⁹ A different problem is that an apportionment formula based on payroll and property would hurt regions that tend to buy more than they produce (i.e., poorer regions in general). One way to redress this imbalance would be to introduce a third factor in the formula based on sales, as is common, for example, in the United States. However, the necessary information to implement this change is not available in Russia at the present time.

⁷⁰ The PIT is generally paid to the jurisdiction where the employer is registered. However, when individuals have more than one more source of income (and therefore have to file a tax return) the PIT is paid to the place of residence.

⁷¹ See McLure (1994), McLure et al. (1996) and Mikesell (1998a).

by the Federation Council will provide the right forum to discuss these issues and reach the national consensus and balance between national and regional interests.

A second issue with regard to the draft *Tax Code* is the assignment of the property tax to the regional level rather than to the local level of government. This assignment has been questioned because of international practice, where this tax is often used as a local tax. However, in the Russian Federation, assignment at the regional level may be justified for administration reasons. A reasonable compromise could perhaps be found by requiring regional governments to share the tax with local governments and giving local governments discretion to add to the tax rate of the property tax within given limits. A further advantage of assigning the property tax at the regional level at this time is that local governments may have no incentive to introduce this or any other tax if the lack of reform of the intra-regional finances implies that the additional revenues at the local level will be clawed back by the regional authorities. At this early stage of development of the real estate property tax in Russia, the emphasis should be put on successfully finalizing the pilot work in the cities of Novgorod and Tver and extracting useful lessons from the introduction of this tax in other subnational governments. Even though the property tax should play a very important role in the financing of Russia's subnational governments in the future, the reality at the present time is that this is a quite distant future. The lack of real estate markets, land ownership and multiple institutional constraints are powerful obstacles for the development of an ad valorem real estate property tax in Russia.

Revenue Autonomy Issues

The most critical concern in the assignment of revenues is that subnational governments in Russia continue to lack adequate revenue autonomy. Revenue autonomy is the key element of a well functioning system of intergovernmental fiscal relations. The draft *Tax Code* provides a greater degree of revenue autonomy to the regions with the introduction of the regional sales tax. A subnational retail sales tax is in theory an adequate instrument to fulfill the goals of revenue sufficiency and autonomy at the subnational level. However, the serious problem with this approach is the high costs of administering and complying with a regional retail sales tax when a VAT already exists at the federal level.⁷² A move to a nationwide retail sales tax at a rate of 5 percent (or even 10 percent, as proposed earlier) and a reduction of the VAT rate to 10 percent is neither optimal nor feasible in terms of revenues. Available estimates indicate that a combination of a reduction in the tax rate for the VAT and regional sales tax with a rate of 10 percent would yield only 60 percent of the revenues now produced by the VAT.⁷³ One of the important reasons for this difference is that the VAT is easier to collect because it is levied at different levels of production. If tax is not paid at some level, it can still be fully recovered at the next level. In contrast, a retail sales tax is only levied on final sales or at the last stage of production where it is most difficult for tax inspectors to

⁷² However, a dual system can exist, in particular where the VAT is a central government tax and the retail sales tax is a subnational (regional) government tax levied at a relatively low rate and on the same base as the VAT.

⁷³ See "The Choice Between the VAT and the Retail Sales Tax in the Russian Federation," Georgia State University Fiscal Reform Project, Moscow, November 1998.

enforce collections. In addition, the international experience indicates that a retail sales tax with a rate of 10 percent will lead to considerable evasion.⁷⁴

A second avenue of increased revenue autonomy in the draft *Tax Code* is the proposed regional property tax. As pointed out above, while the real estate property tax has a great potential, it will take considerable time for this tax to be fully functional. Realistically, this tax will not provide subnational governments with added revenue autonomy soon.⁷⁵ Meaningful and quicker added revenue autonomy at the subnational level could come from a “piggy-back” style regional personal income tax. This tax would use the same tax base as the national income tax and give regional governments the discretion to vary a flat rate up to a maximum set by the federal authorities. This is a proposal that has been on the table in Russia since the beginning of the transition.⁷⁶

Vertical Balance and Revenue Assignments.

Among the most difficult problems to address in revenue assignments is whether or not the revenue sources provided to subnational governments are adequate to cover their financing needs. In order to answer this question, one must first know what the expenditure responsibilities of subnational governments are and at which level of expenditures these responsibilities will be actually fulfilled. The second part, at which level the responsibilities will be actually fulfilled, is difficult or impossible to ascertain *a priori*. In fact for a decentralized system to be efficient, this issue should be decided by the electorate of subnational governments. Giving subnational governments sufficient revenue autonomy offers the most practical solution to the problem of vertical balance. If taxpayers of a subnational jurisdiction consider the level of provision inadequate they can change this by changing their own taxes. Thus, revenue autonomy is the key not only to more efficient expenditures, but also to reaching vertical balance.

⁷⁴ The VAT is generally a more efficient (economically neutral) tax than a retail sales tax. The problem with this later is that it is difficult to avoid the taxation of intermediate production without opening serious avenues for evasion.

⁷⁵ The real estate property tax is planned as a substitute for three current taxes on property: the enterprise asset tax, the land tax and the individual property tax. (Table 21 shows the relative importance of each of these revenue sources, while Table 22 shows how each of these taxes are shared among different levels of government.)

⁷⁶ A piggy-back personal income tax for subnational governments has gained in acceptance in analytical and academic circles in Russia and has been proposed as part of the 1999 budget. Regional aversion to a regional piggy-back PIT may be due to the fact that the revenues from the federal personal income tax are currently assigned entirely to the subnational level.

Revenue Assignments to Local Governments

In the revenue assignments between regional and local governments, little has been accomplished. Many regional governments continue to organize their relations with local governments as in the past. For these regions, revenue assignments are an afterthought for how a negotiated minimum expenditure budget should be financed. Addressing the reform of revenue assignments at the regional-local level in that context would be improper and ineffective. On a more positive note, an increasing number of regions are imitating to some extent the reforms at the federal-regional level. It is clear that a piecemeal approach to revenue assignments at the regional-local level, such as the one followed by the *Law of Financial Foundations of Local Self-Government*, has indeed been ineffective. What is needed at the regional-local level is a reform of the entire budgeting process that governs the relationships between the two levels of governments. These reforms should not only address revenue assignments, but also expenditure assignments, transfers and the budget process itself. The federal government's intentions to spearhead comprehensive reform in this area raises important constitutional issues regarding the extent of federalism in the Russia. These issues have just started to be addressed, such as was the case with the *Law on Financial Foundations*. In essence, but not necessarily in an exact literal way, the steps that will be needed to reform regional-local relations are the same as those for completing the reform of federal-regional relations. This is true whether the federal authorities find the ground to impose these reforms, as in a *Subnational Budget Code*, or the regions are left on their own to carry out these reforms. It is also clear that reforming regional-local relations would be helped by having rational, stable and transparent relations between the federal government and the regions.

CHAPTER IV THE SYSTEM OF TRANSFERS

Intergovernmental transfers in Russia provide a relatively small share of subnational revenues; in 1997, the sum of all federal transfers to subnational governments amounted to only 14 percent of consolidated subnational revenues. At the same time, transfers are not an insignificant source of funding for many individual regions. For an average region, transfers account for 20 percent of the region's budget resources; for ten regions, transfers account for 40 percent or more of regional resources.

Intergovernmental transfers in the Russian system can be divided in two general categories: equalization transfers (transfers specifically provided for the purpose of equalizing differences in fiscal capacities and fiscal needs across regions) and other transfers, including subventions, mutual settlements and a number of other transfers.⁷⁷ Equalization transfers were drastically reformed in 1994, when the system of negotiated subventions was replaced with a formula-driven equalization approach. However, the negotiated and non-transparent nature of mutual settlements continues to provide regions with soft budget constraints and presents regions with perverse collection incentives. At the regional-local level, in many cases transfers are also still negotiated. This presents local governments with the similar problems of soft budget constraints and perverse tax collection incentives.

This chapter is organized as follows. First, we consider the evolution of the Russian transfer system during the transition period. Second, we discuss the current system of transfers. Third, we analyze the performance and incidence of all transfers during the economic transition period. Fourth, we summarize the pending policy issues in the area of transfers and offer some policy recommendations.

IV.1 Evolution of the System of Transfers

The system of intergovernmental transfers from the federal government to the regions has gone through three distinct periods. These periods parallel the different periods of revenue assignments reviewed in Chapter III.

⁷⁷ Mutual settlements, as discussed later in this chapter, form an umbrella category of transfers, consisting largely of unbudgeted, non-transparent transfers which get allocated during the process of budget execution.

Transfers in the Early Years of the Transition

During 1992-1993 the bulk of all transfers were negotiated “subventions” to those regions for which own revenues and shared revenues were not large enough to fund the minimum expenditure budget that was negotiated, as a first step, with the Ministry of Finance. The entire budgetary process, and by association the determination of these lump-sum subventions, lacked transparency and was subject to political manipulation and pressure. Despite these shortcomings, as discussed in greater detail below, these transfers had some positive equalization effects. The same methodology of negotiated transfers was followed at the regional-local level. Regions designed gap-filling subventions for those local governments in which own and shared revenues were not large enough to fund their minimum expenditure budgets.

The Reform of Transfers in 1994

In 1994 the Russian government introduced a new system of formula-driven equalization transfers which, with some minor adjustments, was used until 1998. However, the formula was only used in earnest in 1994 and 1995; in later years, the formula's results were subjected to political negotiation. Alongside the formula-driven equalization transfers the government continued to use a number of other types of transfers which were mostly of an *ad-hoc* and non-transparent nature.

The *Fund for Financial Support of the Regions (FFSR)*, as the new system of equalization transfers was called, had two equalization “windows.” The first window (called “Regions in Need of Financial Assistance”) attempted to equalize the availability of revenues across regions. The second window (called “Regions in Need of Additional Financial Assistance”) attempted to provide additional funding to regions with unmet expenditure needs. The system first determined the overall level of funding and, second, allocated equalization transfers to the regions using two sets of formulas, one for each window.

The overall level of funding for the FFSR was determined every year in the federal budget. The funding rule for the FFSR has been subject to change virtually on an annual basis. In 1994, the funding for the FFSR was set at 22 percent of the federal share of VAT collections. This was increased to 27 percent of federal VAT collections in 1995. For 1996 and 1997, the funding rule was changed to 15 percent of all federal tax collections, exclusive of import duties.⁷⁸ The 1998 budget lowered overall funding to 14 percent of federal collections with the same exclusions.

The formula for the first window of the FFSR had three steps (Table 31). Although the basic formula did not change over the years, some of the coefficients did change from year to year. For 1997, the first step used revenues per capita adjusted from a base year (the most recent year for which data were available) to equalize revenues across the regions. Revenue data from an earlier year were used to reduce disincentives to revenue mobilization. For the purpose of determining FFSR transfers, the Russian Federation was divided up into three groups of regions (two groups of regions in the Northern territories

⁷⁸ For 1996 the federal share of the PIT, set at 10 percent, was also excluded from the FFSR funds.

and one for the rest of the Federation) mainly to capture differences in the cost of living.⁷⁹ Within each of these three groups, regions whose adjusted per capita revenue collection (based on the base year) were below 92 percent of the group average were entitled to capacity-equalizing transfers.⁸⁰ Steps two and three of the first window determined the actual size of the transfer by apportioning the available funds to those regions with a positive claim in the first step.

The formula for the second window of the FFSR (Table 31), in its 1997 version, was based on expenditure data for the base year of 1991.⁸¹ These data were adjusted for changes in legislation for the years in between in order to approximate the levels of expenditure needs for all regions for 1997. Revenue capacity for the second window was determined the same as in the first window. Each region's claim to a transfer in the second window was then computed as the difference between the estimated expenditure needs and the sum of adjusted revenues and the transfer from the first window (if any). Again, the remaining steps apportioned the funds allocated to the second window to those regions with positive expenditure gaps.

The FFSR system had several significant weaknesses:

- C after 1995, the transparency and objectiveness of the FFSR approach was compromised by subjecting the formula's results to political negotiations.
- C the equalizing capacity of the system was limited by the fact that the funds available for equalization were a relatively small share of the subnational budget.
- C continued changes in the formulas for both windows turned many regions against the system when the changes did not hold them harmless against losses of funding.
- C there was a widespread perception that the mechanism did not achieve the goal of equalization of resources between the regions.
- C the use of actual revenue collections and actual expenditure per capita data from a base year did not accomplish the task of properly measuring fiscal capacity and expenditure needs. For instance, the assumption that expenditures for 1991 reflected the expenditure needs of the regions in 1997 was not realistic, especially in light of the sweeping changes in the economic structure of Russia during the transition period.
- C the division of regions into geographical groups may have prevented equalization across groups and did not control adequately for differences in the cost of living across regions.
- C the formula for the second window essentially followed the "gap filling" philosophy of the subvention system that was used during 1992-93 and previously in the Soviet Union.

⁷⁹ In 1996 and before, the Federation was divided up into 11 groups of regions for this purpose.

⁸⁰ The scaling coefficient was 0.95 for the years from 1994-1996. The coefficient acts to scale down the level of equalization.

⁸¹ Until 1996, the base year for the purpose of measuring expenditure needs was 1993. The switch to 1991 was based on the belief that this year's expenditures were more representative of actual expenditure needs.

- C the gap-filling approach and the annual adjustment process arguably introduced perverse incentives in the FFSR system, as regions who increased revenue collections had a legitimate concern that their FFSR transfer would be reduced.

Beside the FFSR transfers, several other types of transfers were used during the 1994 to 1998 period. None of these transfers were based on formulas or rules, and in many years, the funds allocated through these other transfers exceeded those allocated through the FFSR.⁸² The most important of these other forms of transfers were “mutual settlements.” Mutual settlements are transfers arranged after the annual budget law has been adopted. However, in actuality mutual settlements form an umbrella category of transfers that include transfers to compensate regional governments for mandates or the delivery of federal programs, emergency transfers, and transfers in lieu of financing regional investment programs in the federal budget.⁸³ Many different forms of negotiated and discretionary funds were also included in mutual settlements. Since 1994, a key component of mutual settlements has been ex-post negotiated payments to subnational governments for the maintenance of housing. A key (negative) feature of these mutual settlement transfers is that these funds were never budgeted. Instead, these transfers were determined and negotiated in the process of budget execution. All but a handful of regions were recipients of mutual settlement funds.

Other transfers used in the Russian system of intergovernmental fiscal relations include grants to the city of Moscow for performing the role of capital city, to the city of Sochi, to the Northern territories for the delivery of goods, and grants to “closed” cities.⁸⁴ Although not transfers *per se*, “budget loans” from the Ministry of Finance to regional governments often became transfers when they were written off after the close of the fiscal year. As in the case of mutual settlements, many of these other transfers have been assigned on an *ad hoc* basis and have lacked transparency (Morozov, 1998).⁸⁵

⁸²See IEPT (1998), Freinkman et. al. (1998), and Morozov (1998), and Titov (1997).

⁸³ In the case of many federal mandates, current budget legislation does not require that these expenditures be compensated through mutual settlements. Instead, these expenditures (including the anticipated expenditures associated with federal mandates to be adopted during the year) are included into the estimate of the expenditure needs of the regions, so equalization transfers should ideally include funding for these federal mandates and other expenditures. However, in reality federal mandates do not get compensated either through mutual settlements or transfers.

⁸⁴ Closed cities are part of the military-industrial complex and subject to maximum security. Their budgets have been handled directly by the Ministry of Finance and they are reputed to have enjoyed a privileged standard of living (Campbell, 1996).

⁸⁵ Some regions also receive support from the federal government via funds allocated to particular sectors or even to enterprises in particular regions, such as those in the coal industry or agriculture. A few regions also have been granted the special status of tax free zone (IEPT, 1998).

The Reforms of 1998

The general dissatisfaction with the FFSR mechanism used since 1994 led to its gradual demise, as the formula's results were subjected to modification through political negotiations between the State Duma and the regions from 1996 to 1998. For 1999, the Russian government has introduced a new equalization formula for the FFSR. The new mechanism has only one window and the formula has been simplified (see Table 32). The crux of the formula consists of the use of *index of budget expenditures* (or expenditure needs) to “normalize” or adjust per capita revenues. The new formula assigns equalizing transfers to regions for which the normalized per capita revenue falls below some threshold.

IV.2 The Current System of Transfers

Three elements of the current system of transfers are considered in this section: equalization transfers, other transfers (mutual settlements, etc.), and regional-local transfers. While budget loans are sometimes considered transfers due to the high frequency with which they are forgiven by the federal government, they will be considered as part of deficit finance in Chapter V.

Equalization Transfers

The new formula for the FFSR is an improvement over the past formula. It is simpler and it gets closer to the ideal of using “fiscal capacity” and “expenditure needs” rather than actual revenues and expenditures for a base year as the standards for equalization.⁸⁶ Like the original FFSR mechanism, the new formula for the FFSR also has two components: the determination of funding and the equalization formula. The overall level of funding for the FFSR will still be determined in the annual budget as a share of federal tax revenues exclusive of import duties.⁸⁷ This is the first step of the new equalization formula (Table 32).

The basis of the new equalization mechanism is formed by a measure of revenue collections (or fiscal capacity; step 2) and a measure of budget expenditures (or expenditure needs, step 3). The mechanism then “normalizes” each region's level of fiscal capacity by the index of expenditure needs (step 4). The normalization of per capita revenues means that regions with higher expenditure needs are considered to have lower normalized per capita revenues. Each region that has below-average normalized per capita revenues could potentially receive a equalization transfer. However, if insufficient funds are

⁸⁶ See Boex and Martinez-Vazquez (1998a) for a complete review of the new equalization formula and suggestions for improving the formula.

⁸⁷ For 1999, the FFSR is budgeted to receive 14 percent of applicable federal revenues. Based on the draft Medium Term Fiscal Plan for the Russian Federation, the FFSR fund is planned to shrink further to 11 percent by 2001.

available to equalize all below-average regions, the equalization threshold is gradually lowered until the neediest regions can be pulled up to the threshold level (steps 5 and 6).

The crucial issue for the performance of the current formula is the specification of the measures of fiscal capacity and fiscal need. As currently conceived, the new equalization formula uses per capita revenues as a proxy for fiscal capacity. For 1999 the measure of per capita revenues will be based on 1997 data. For future years, it appears that the plan is to either make annual adjustments to the measure and eventually to substitute per capita revenues with a more appropriate measure of regional fiscal capacity. As a proxy for expenditure needs, the plans are to use a measure of differences in the cost of living across groups of regions for 1999. For future years, the Ministry of Finance expects to develop a comprehensive set of norms to estimate differences in expenditure needs across regions.

The selected measures of fiscal capacity and fiscal need present two main areas of concern with the new FFSR formula. With regard to the measure of fiscal capacity, using actual collections data for 1997 for the 1999 budget will continue to send the wrong message to the regions regarding their levels of tax effort. When up-to-date data for tax bases or the composition of gross regional product (GRP) become available it will be possible to improve on the measure of fiscal capacity.

The second main area of concern is the proposed use of expenditure norms for the purpose of calculating regional expenditure needs by the year 2000.⁸⁸ Whether the plans are to go back to using “physical norms” (as those used in the Soviet era) or more broadly defined per capita norms is not clear at this time.⁸⁹ However, it is clear that these norms will be approved by law. While there is no problem with the use of cost or funding standards in the formulation of the budget, there are important problems associated with the explicit use of norms legislated in the law. Three of these problems are as follows:

Budgeting from Norms Results in Suboptimal Fiscal Management. A conspicuous feature of budget preparation in Russia is the philosophy or the overall belief that budgets should be viewed from a perspective of needs rather than from a perspective of feasible public services given the current revenue resources. This perspective has led to a history of unrealistic budgets and poor performance.

It should be understood that all budget practitioners *de facto* use some form of norms or expenditure benchmarks to compile a budget. There is inherently nothing wrong with this practice. However, it is problematic when norms or benchmark expenditure levels for different functional expenditure

⁸⁸ More accurately, the plans call for the possible phasing-in of budget norms during 1999 for housing and utilities, health care, education, social welfare, public transportation, culture and public administration. For the year 2000 all regional expenditure needs should be solely determined on the basis of norms.

⁸⁹ Numerous attempts have been made in the past years to estimate different indices of need. Lavrov (1998) discusses these indices, including those developed by the Ministry of Finance, the Ministry of Economy, the Central Research Institute of Economics, the State Committee for Construction and so on. He finds that there are very significant correlations among most of them.

categories are established by law or fixed in some other way without considering the attached funding implications. This carries the risk of raising the expectation that a certain level of public services will be provided, while sufficient funds may simply not be available to deliver these services. This is the approach followed in the previous regime; it clearly did not work then and it will not work now. In contrast, *de facto* norms can be used to assist budget practitioners in successfully allocating funds within the relevant budget constraint without raising such expectations.

Also, in a decentralized federalist system the role of the federal government in providing for equalization between different regions is often less extensive than in the Soviet tradition. Indeed, a certain degree of variation in regional expenditures should be considered beneficial as it allows regional governments to adjust spending patterns to region-specific concerns and respond to regional demands for public services. In addition, the use of budgetary norms would convert the budgetary process into an input-oriented activity, making it more difficult to focus on budget performance and the level and quality of services. In general, budget norms tend to suppress the practice of budget evaluations,

Physical Norms Provide Wrong Fiscal Management Incentives. Perhaps the most important drawback of budgetary norms based on physical measurements is the fact that these norms provide incentives that are not compatible with the goal of the efficient allocation of budgetary resources. For example, physical norms based on physical infrastructure capacity (number of schools, number of hospitals, etcetera) give subnational governments an incentive to generate excess capacity or preserve obsolete capacity.

In addition, the use of physical expenditure norms in the assignment of transfers may actually cause greater inequality between the regions. Greater disparities could occur if, under the present regime, wealthier or politically favored regions have been able to enlarge their physical capacity (for example, more hospitals or universities) than poorer or less favored regions with similar public services needs. If physical expenditure norms are used to measure expenditure needs, the wealthier regions would be considered to have greater need and thus receive a greater share of the equalization fund.

It should be noted that such problems can be avoided by setting per capita monetary norms instead of physical norms. If expenditure need is measured by something other than physical measurements, public officials will have an incentive to close up (rather than maintain) excess capacity in schools and clinics and to allocate the available funds to improve the quality of service at the remaining locations.

Norms Are Not Transparent and Are Administratively Costly. A further argument against the adoption of expenditure norms is that the use of a large number of norms causes the budgetary system to become complex and administratively costly while losing its transparency. Especially the practice of setting expenditure norms in isolation of revenue availability is likely to result in public disenchantment and frustration. If revenues fall short to fulfill the announced norms, the expenditure norms will have to be reduced through negotiations to achieve budgetary balance. This raises the concern that in the time of several years, the measure of expenditure needs may once again become so convoluted that the equalization system will *de facto* return to a situation of politically negotiated transfers. In addition, the use of physical norms will result in public frustration and political friction as taxpayers feel cheated when the

government cannot fulfill its promises and place blame with subnational elected officials who are unable to delivered the level of services established by the norms.

A variety of measures of expenditure need exists which could be used in the allocation of equalization transfers. One measure that has recently received increased attention from the Russian government is the Representative Expenditure System, a measure of expenditure needs developed by the U.S. Advisory Committee on Intergovernmental Relations (1990). Although this approach is theoretically sound, it assumes the existence of budgetary discretion and revenue autonomy by subnational governments at levels which have not been in place during the transition in Russia.

Mutual Settlements and Other Transfers

Despite the continued reform of the FFSR mechanism, the Russian government has continued to rely on mutual settlements and other *ad hoc* types of transfers. In this category, mutual settlements are the dominant form of these other transfers, accounting for about 25 percent of all transfers (including the FFSR) and 75 percent of non-equalization transfers. Mutual settlements were already in existence before the transition and they were used to compensate the budgets of lower-level governments for changing in tax legislation or the adoption of federal laws introducing new expenditure mandates. During the transition, mutual settlements have been mostly a one-way stream of transfers from the federal to regional governments, and their content has been enlarged to include emergency grants, block grants and settlements to substitute for the financing of regional investment programs (Morozov, 1998).

A final group of transfers consists of block grants to the cities of Moscow, Sochi and the “closed cities” as well as some “subventions.” These subventions are truly earmarked grants which may be allocated for capital expenditures or for current expenditures. The State Duma determines these grants in negotiations with the government and the regions. This group of transfers accounts for approximately 25 percent of all non-equalization transfers, but only as 10 percent all transfers.

Two main issues arise with regard to the manner in which these non-equalization transfers have been allocated. First, these transfers fail to provide a stable budgetary environment as none of them are allocated based on objective, pre-determined and transparent criteria such as formulas. Earmarked transfers continue to be allocated through bargaining and budget negotiations; mutual settlements most often are not budgeted at all. Second, in combination with the availability of budget loans and other means of financing for current expenditures (discussed in Chapter V), mutual settlements continue to provide a soft budget constraint for regional governments.

Regional-Local Transfers

As discussed in Chapter II (expenditure assignments) and Chapter III (revenue issues), to a large extent regional-local relations continue to mirror the system of intergovernmental relations during the Soviet regime. Often, minimum expenditure budgets are negotiated between the regions and local governments

supposedly based on a number of expenditure norms. The revenue gap between a locality's expenditure needs and own and shared revenue sources is addressed using negotiated gap-filling transfers. The continued reliance on this outdated approach preserves the major incentive problems at the regional-local level that were prevalent in the previous system.

Some regions have moved to introduce standard sharing rates for revenue sharing within the regions; this is the case in Sverdlovsk, Penza and some other regions (Igudin, 1998). Most often when revenues are shared at a standard rate, the local shares tend to be relatively low to avoid wealthier districts and municipalities from attaining large fiscal surpluses. This leaves an increased role for transfers at the regional-local level.

The analysis of one specific region may provide some additional insights into the issues surrounding intra-regional relations. Recently, Bahl et al. (1998) provided a comprehensive review of intergovernmental transfers in Leningrad oblast. Leningrad oblast uses three types of grants for its local governments: subventions, paid to local governments as earmarked grants to cover price subsidies for medicines and to partially compensate communications companies for mandated rate reductions for pensioners and others; subsidies, which are paid to local governments essentially as gap-filling transfers to cover the general shortfall between the minimum expenditure budget and the rayon's other revenue sources; and mutual settlements, which basically serve a similar purpose as they do at the national level of ex-post unbudgeted transfers to lower-level governments. The role that mutual settlement play within Leningrad oblast's system of transfers is more important than at the national level, accounting for about 45 percent of all regional transfers. The gap-filling subsidies account for approximately the same share of regional transfers; the earmarked transfers only cover around ten percent of all regional transfers.

IV.3 How Has the Transfer System Performed?

Transfers Have Been Relatively Small And Tended to Decrease over Time

At their peak in 1994, on average transfers represented 35.8 percent of funding for regional governments. As shown in Table 33, by 1997 the significance of transfers and other settlements had declined to only 19.8 percent. The decline in the importance of intergovernmental transfers as a subnational source of funding has been taken up largely by "other sources of financing," mainly consisting of budget loans and different forms of borrowing. The most significant decrease in transfers took place in 1995; while mutual settlements and other (non-equalization) transfers on average represented 26.4 percent of all regional funds in 1994, this percentage dropped to 5.6 percent in 1995. The relative role of equalization transfers in subnational budgets has remained fairly constant over the last three years. In 1997, an average of 15.6 percent of subnational public funds of all regions consisted of FFSR transfers.

The level of federal transfers to the regions expressed as a share of GDP provides yet another useful perspective on the relatively small significance of these funds (Table 34). In 1997, total federal

transfers (excluding budget loans) represented 1.92 percent of GDP. When budget credits and loans from the federal government to the regions are also taken into consideration, this figure increased to 2.67 percent for 1997. These figures have been more or less representative of the past five years. The exception was 1994, when the introduction of the FFSR and a sharp increase in mutual settlements pushed total federal transfers and loans to the regions to 4.21 percent of GDP. In real terms (1995 prices) per capita transfers have been up and down over the past years. For an index of 100 for 1994, federal transfers (excluding budget loans) to the regions had been at 22.7 in 1992 and at 41.4 in 1997 (Table 35).

Although by design the FFSR is supposed to be equalizing, this mechanism has been criticized since its introduction in 1994 for failing to accomplish this objective. A different but also important question is whether all other transfers have had an equalizing effect. If this was not the case, to what extent did these transfers offset the equalization obtained through the FFSR? It is important, therefore, to consider the equalizing effect not only of the FFSR, but of the entire system of transfers, and ultimately of the entire system of intergovernmental relations.

Have Transfers Been Equalizing?

Whether the FFSR has actually been equalizing has been one of the most analyzed issues in Russian fiscal federalism and, to some extent, the answer to this question depends on how one chooses to answer it.⁹⁰ The influence of economic factors on the allocation of transfers is analyzed in Table 36 and 37. In Table 36, per capita FFSR transfers are regressed on per capita GRP (a measure of fiscal capacity) and several measures of need (cost of living, percent of the population under and over working age, and percent in poverty).⁹¹ For all years the coefficient for per capita GRP is negative, and statistically significant for the last three years. Thus, wealthier regions receive fewer FFSR transfers. The positive and statistically significant coefficients in all years for cost of living and young and old population also tell a strong equalization story. On the other hand, the percent of the population living in poverty in a region never affected the FFSR transfers in any of the years under consideration.

The regression analysis of per capita “other transfers” for the years 1994 through 1997 (Table 37) tells a similar, but not as compelling, story of equalization. The category “other transfers” is defined to include subventions, mutual settlements and some other types of minor transfers, but excludes budget loans. The regression coefficients for per capita GRP are always negative but only statistically significant for two out of the four years. Regions with higher expenditure needs, as measured by the cost of living and percent of the population under and over working age are also positive, but not always significant for 1994 to

⁹⁰ Le Houerou and Rutkowski (1996), Stewart (1996), and Martinez-Vazquez and Boex (1997) concluded that transfers, for the most part, have not been equalizing. In fact political considerations, in particular the appeasement of regional troublemakers, have been identified as more important determinants of the flow of transfers to the regions (Treisman, 1996; 1998a,b).

⁹¹ See Table 10 for the descriptive statistics of these variables.

1996.⁹² However, in 1997 these transfers became dis-equalizing in terms of “needy” population; the regression coefficients for the young and old population became negative and statistically significant. This suggests that in 1997 regions with a disproportionately small economically active population receive fewer “other transfers.”⁹³

Thus, what is the conclusion on the question of whether the allocation of transfers has been equalizing? Probably the right answer is that FFSR transfers overall have been equalizing. The incidence analysis in Table 36 suggests that economic factors have been important in determining the allocation of FFSR transfers and that these transfers have been allocated in an equalizing manner. This is not the case for the “other transfers” analyzed in Table 37. The explanatory power of the economic variables included in the regression has steadily declined over time; by 1997, only roughly one-third of the variation in these transfers could be explain by economic variables. As far as economic factors do influence the allocation of these transfers, the parameter estimates suggests a much weaker pattern of equalization for “other transfers” than is the case with the FFSR.

Further analysis suggests that transfers on the whole have had a limited impact on reducing fiscal disparities. This is shown in the regressions in Tables 38 through 41. These tables analyze the impact of FFSR transfers and other transfers on per capita expenditure disparities across regions in the context of the rest of the fiscal system. This analysis is carried out separately for each year from 1994 to 1997. For each year, we define five dependent variables in per capita terms: total collections in the regions (which includes the federal share of shared taxes), regional revenues before transfers of any kind, regional revenues after FFSR transfers, regional revenues after all transfers, and finally regional expenditures. Comparing the parameter estimates for each step with the previous step allows us to conclude whether or not the step has been equalizing.

With a few exceptions, the impact of transfers has been to reduce the role of fiscal capacity (per capita GRP) in the allocation of subnational resources. In addition, transfers have generally been allocated to regions with higher expenditure needs (as proxied by cost of living, and percent old and young population). Ultimately, the equalizing impact of transfers has weakened considerably in later years. And, as the regressions for per capita regional expenditures show, differences in regional fiscal capacity continue to cause substantial disparities in regional expenditure levels.⁹⁴

⁹² Stewart (1996) also notes that both FFSR and other transfers can be interpreted as equalizing vis-a-vis expenditure needs.

⁹³ The dependent variables in Tables 36 and 37 do not take into account the fact that transfers to different regions may actually provide different levels of fiscal support due to regional price differences. All else equal, a federal transfer to a region with a relatively lower price level has a more equalizing effect. Therefore, the regressions contained in Tables 36 and 37 were also estimated using real per capita transfers levels (adjusted for the regional cost of living) as dependent variables. The regression results and conclusions were unaffected by this adjustment.

⁹⁴ Disparities in expenditures per capita are discussed more fully in Chapter II.

Have Transfers Discouraged Tax Effort By Regional Governments?

One of the most serious criticisms of the system of equalization transfers in force for the 1994-1997 period was that its formulas gave regions the perverse incentive to lower their tax effort. This issue is explored in the regression in Table 42. In these regressions, the dependent variable, tax effort, is defined as the level of regional tax collections expressed as a percentage of gross regional product (GRP).⁹⁵ The regression coefficient for FFSR transfers (defined as a percent of total regional expenditures) is negative for all four years and statistically significant, except for 1997. The negative impact of FFSR transfer on tax effort is not extremely pronounced but neither is the impact immaterial. For example, in 1996 for every ten percent increase in FFSR transfers as a share of the regional budget, other things equal, the tax effort ratio decreased by one-half percent.⁹⁶

The empirical evidence indeed appears to suggest that FFSR transfers have discouraged tax effort. However, shortcomings in the way in which tax effort is defined (as the ratio of revenue collections to GRP) allows for alternative explanations. It is possible that GRP is a poor measure of regional fiscal capacity due to the fact that it does not consider the economic composition of a region. For example, the measure of GRP may overstate the fiscal capacity of regions that rely heavily on agricultural production. If these agricultural regions have a more limited ability to raise revenues, then the measure of tax effort (the dependent variable) would understate their actual level of effort; as a result, the regression would reveal a negative relationship between tax effort and FFSR transfers. Also, the measure of fiscal effort may also fail to take into account higher expenditure needs for certain types of regions. If regions for which GRP overstates their fiscal capacity systematically have greater legitimate expenditure needs (for example, for maintenance of infrastructure), this could again result in an allocation of greater amounts of FFSR transfers to regions with a lower level of measured tax effort.

Discouragement of tax effort has been more pronounced at the local level where negotiated minimum expenditure budgets, regulating sharing rates and negotiated transfers often still prevail. Zhuravskaya (1998) studied the budgets of 35 large cities in 29 regions from 1992-97 and found that for every ruble that local government own revenues increased in a given year, about 90 kopeks were clawed back or extracted by reductions in transfers and/or tax sharing by the regional governments.

⁹⁵ The same set of regressions but with tax effort defined in terms of overall collections (including the federal share) are presented in Table 43. The results are virtually similar to those obtained when only regional revenues are incorporated in the measure of tax effort.

⁹⁶ Other control variables are used in these regression explaining the variation in tax effort across regions. These parameters suggest that regions with higher per capita GRP and more dependent on revenues from the PIT tend to exert a lower effort. Those regions more dependent on business and sales taxes tend to exert higher tax effort

Budgeted Transfers and Actual Transfers Have Differed Considerably

One important source of dissatisfaction among the regions with the FFSR has been the time lag between the crediting of taxes to the federal budget and the final remittance of funds to the regions from the FFSR. Indeed, the problems in administering the FFSR have gone beyond delays. The record on actual implementation of budgeted transfers is poor. As Table 44 shows, there have been significant deviations, in both directions, from the budgeted amounts to the actual amounts received in the execution of the budget. These deviations, present for 1995, 1996, and 1997 are hard to explain; anecdotal evidence suggests these deviations may be the result of political factors. However, these deviations may also have arisen due to the extensive use in recent years of budgetary loans.

IV.4 Pending Policy Agenda for the Reform of Transfers

The overhaul of the entire system of transfers is crucial to the overall success of the reform of intergovernmental relations in the Russian Federation. Without addressing the current problems with the transfer system as a whole, subnational governments will continue to face fiscal incentives that reward irresponsible fiscal behavior.

The Russian government's reform agenda in the area of transfers is outlined in the "*Concept of Reform of Inter-Governmental Fiscal Relations*." The reform agenda with regard to transfers should contain reform proposals in three broad policy areas. First, improvements to the new FFSR equalization mechanism should be considered. Second, sweeping reforms are needed to replace the current system of non-transparent and ad-hoc mutual settlements, forgiven loans and special subventions, with a system of budgeted, objective and transparent transfers that target federal government objectives other than equalization. Third, the issue of regional-local transfers needs to be redesigned in the context of wider reforms in revenue assignments and the assignment of expenditure responsibilities.

*Reforming the System of Equalization Transfers*⁹⁷

The introduction of the formula-driven equalization mechanism in 1994 and its further improvement in 1998 were two major steps in the direction of a objective, transparent and effective equalization mechanism. Nonetheless, a number of issues continue to prevent the FFSR from achieving its intended goals.

The Funding Rule. The funding rule for the FFSR should be reevaluated in light of a number of considerations. First, the determination of the appropriate funding level for the FFSR is clearly a political choice that requires finding a balance between the objective of equalization and spending on other

⁹⁷ Many reform proposals have suggested in recent years. See Rafuse (1996), Martinez-Vazquez and Boex (1997), Lavrov (1997), IEPT (1998), Morozov (1998), and Boex and Martinez-Vazquez (1998a).

government programs. In this regard, it is also important to realize that the redistribution of funds to poorer regions inevitably requires taxing better-off regions, which in turn, may slow overall economic growth. A second consideration in the determination of the funding rule is the trade-off between stability and flexibility. The current approach of deciding the level of funds in each year's budget provides the federal government with desirable flexibility, but it sacrifices certainty for regional governments. A common international practice is to fix the overall funding as a percent of central government revenues for a period of three years, which can only be altered in the case of an a priori stipulated emergency situation. This may also be a workable compromise for Russia. A final consideration with regard to the funding rule is the modality for financing the equalization mechanism. Equalization can be achieved either through vertical arrangements (using federal sources) or through a horizontal or "fraternal" approach (sharing of regional sources). In the latter case, better-off regions would have to contribute some of their own revenues to an equalization fund. The "fraternal" approach, common in Scandinavian and some Central European countries, and also partially adopted in the Baltic states, is unlikely to be accepted in Russia.

Improving the Equalization Formula. A second set of issues surrounding the equalization mechanism focuses on improving the equalization formula. Improvement of the formula is suggested in three directions:

- C The measure of fiscal capacity used in the equalization process should be improved to avoid the incentive problems raised by using past actual collection. A number of fiscal capacity measures that could serve this purpose are discussed Boex and Martinez-Vazquez (1997a) and computed for the regions of the Russian Federation in Boex and Martinez-Vazquez (1997b).
- C Similarly, the measure of regional expenditure needs should be reconsidered. Alternative measures of expenditure needs are per capita monetary expenditure norms, indices of fiscal needs based on broad social and economic measures of need and the Representative Expenditure System. The use of monetary norms and expenditure needs indices as measures of fiscal need is discussed by Boex and Martinez-Vazquez (1998a). A preliminary approach and initial estimates for a Representative Expenditure System for the Russian Federation were developed by Rafuse (1996).
- C A third, more arguable improvement to the equalization formula would be the introduction of stimuli to increase the level of tax effort by regional governments. The reforms of 1998 did not incorporate any such stimulus to tax effort. Instead, in order to increase the tax effort of regions, each FFSR recipient-region was required to put in place a program to increase own revenue collections. These programs must be approved by regional legislative acts as well as by the Ministry of Finance of the Russian Federation. Although a generally accepted principle in fiscal federalism is that transfer systems should neither encourage nor discourage tax effort, encouraging tax effort may be temporarily justified if a problem with subnational collections exists such as in the case of Russia. Introducing a stimulus to tax effort in the equalization formula is not complicated and it should prove

more effective and much simpler than signing separate revenue raising agreements with the regions.⁹⁸

The overriding objective of these reforms would be to arrive at a transparent equalization formula that achieves its goal of equalization without unnecessarily providing incentives to the regions to lower revenue collections.

Depressed Regions. A third issue in the design of the equalization mechanism is whether or not there is a need for special transfers or a special fund for “economically depressed” regions in Russia.⁹⁹ This option may be quite suited to Russia given the large fiscal and economic disparities between the regions and the fact that there is a core of regions that is dismally poor. At the same time, the newly introduced equalization formula already focuses much greater attention on the neediest regions than was previously the case. The implementation of an equalization program for economically depressed regions would call for criteria to objectively identify depressed regions and require an adapted formula to distribute the available funds among the qualifying regions.¹⁰⁰

Holding Harmless. A final consideration with regard to the formulation of equalization transfers is whether or not regions should be held (partially) harmless for the reform of the equalization system. The experience during the discussion of the 1997 and 1998 budgets by the State Duma clearly indicates the importance of this issue. Reputedly, one main reason for the dissatisfaction of the State Duma with the FFSR allocations for the 1998 budget was that it would harm a number of regions *vis-a-vis* what these regions received before. The obvious advantage of holding regions harmless is that reforms become more politically acceptable. The disadvantage of holding regions harmless is that it sacrifices funds that would be otherwise available for equalization. Nevertheless, some transition measures should be considered if they result in political acceptance for an improved equalization mechanism.

⁹⁸ See Boex and Martinez-Vazquez (1997a) and Martinez-Vazquez and Boex (1997). The provision of incentives to encourage tax effort does raise a number of policy issues. For example, Table 42 suggests that over the period 1994-1997, the relative level of tax effort exerted by wealthier regions has increased over time. Fiscal incentives to increase tax effort could therefore make the system of transfers less equalizing.

⁹⁹ The 1998 Budget of the Russian Federation mandated the distribution of 1.2 billion rubles among “depressed regions.” The Budget neither proposed any scheme or formula for the distribution of these funds nor identified the “depressed regions.” A few other countries besides the Russian Federation set aside a special pool of transfer funds for depressed or especially disadvantaged regions. For example, Canada’s Territorial Formula Financing provides special transfers to disadvantaged regions (Yukon, North West Territories and Nunavut Territories).

¹⁰⁰ See, for example, Martinez-Vazquez, Boex and Bahl (1998).

Introduction of Categorical Transfers

While a great deal of attention has been paid to the reform of the FFSR, the reform of the remainder of the transfers system has received insufficient attention. The current myriad of transfers, including mutual settlements, forgiven loans, and other forms of transfers, provide an unstable and non-transparent source of funding for regional governments while providing perverse fiscal incentives. The use of mutual settlements should be discontinued in favor of a system of formula-based, transparent and objective categorical transfers.

The public finance literature suggests that, in addition to equalization, intergovernmental transfers can be used to pursue several types of legitimate federal policy objectives. In order to achieve these multiple goals, the Russian government should design a system of transfers using separate transfer programs for each of the separate objectives that it wants to pursue.¹⁰¹ A general constraint in the design of transfers in Russia has been the limited ability of the federal authorities to monitor the actual behavior of regional governments and the lack of enforcement mechanisms. Notwithstanding those problems, the federal government could introduce the following:

- C explicit categorical grants, earmarked for programs of national policy significance such as those in education, health, or the environment;
- C direct transfers to compensate subnational governments for federal programs implemented by subnational governments or to compensate regions for previously unfunded mandates;
- C a set of matching grants to provide incentives to subnational governments to increase expenditures in areas with externalities, such as different forms of infrastructure, or again, those with national significance such as education and health.¹⁰²

One feature of Russia's system of transfers has been the lack of focus on capital investment needs.¹⁰³ This is important not only because of the vast need to rehabilitate and expand social and physical infrastructure but also because there exist very significant differences in capital infrastructure among the

¹⁰¹ One lesson in grantsmanship design, not yet internalized in Russia, is that the pursuit of multiple objectives with one single instrument seldom performs as desired. The use of equalization grants from the FFSR for funding part of the regional health insurance funds in 1997 is an example of this confusion of objectives.

¹⁰² The option of matching grants has not been given strong backing in government circles in the past because of the lack of an appropriate regulatory and enforcement framework to enforce matching requirements (Morozov, 1998)

¹⁰³ Morozov (1998) states that all federal transfers have had an anti-capital investment bias. However, to the extent that these transfers have been mostly lump-sum, regional governments were in principle free to use these funds for capital investment. Perhaps, it would be more appropriate to say that none of the transfers had the explicit objective of promoting investment in infrastructure by subnational governments.

regions with which they were endowed under the former Soviet Union. The “*Concept of Reform of Inter-Governmental Fiscal Relations*” calls for the creation of a new transfer fund, “Investment Support of Regional Development,” to address the lack of focus in the past on capital infrastructure at the subnational level. This is not, properly speaking, a separate fund, but rather a methodological integration of federal and regional programs and sectoral programs on investment already taking place. The main idea of this approach is to create an integrated investment plan for the regions under the coordination of the Ministry of Economy which would provide matching capital investment grants to the regions. This may prove to be the right approach to the needs for capital infrastructure at the subnational level, presuming the process does not become overly bureaucratic.¹⁰⁴

The “*Concept of Reform*” also calls for the creation of the “Regional Finance Development Fund” with the objective of providing incentives to subnational governments to reform their public finances and to encourage revenue raising and expenditure rationalization. This would be accomplished through the granting of loans with conditionality for reform by the regions. This will also prove to be a useful program if it is used to encourage the implementation of a *Regional Budget Code*. But this latter has not been yet developed.

Reforming the System of Regional-Local Transfers

As pointed out earlier in this chapter, at the regional-local level transfers are often still used for gap-filling purposes. Indeed, in many regions the entire system of regional-local relations has simply been carried over from the previous system. Since this system is based on a “minimum expenditure budget,” regulated sharing rates and gap-filling transfers, the mechanism lacks any incentives for local governments to collect any own source revenues. Although expressly forbidden in the *Law on the Financial Foundations of Local Self-Government* of September 1997, many regions continue the practice of clawing back increases in local collections by reducing transfers to localities. The heedless use of gap-filling transfers at the regional-local level will perpetuate both the poor fiscal incentives as well as the resulting suboptimal fiscal behavior at the local level.

As concluded in Chapter III, what is truly needed at the regional-local level is a reform of the entire budgeting process that governs the relationships between the two levels of governments, including the allocation of transfers. However, such an overhaul cannot be simply mandated or imposed from the top down and will take time to take hold. In the mean time, several improvements can be made within the framework of the current system of transfers at the regional-local level that would greatly reduce the incentive problems associated with the current system. These improvements would rely on using measures of expenditure needs (as opposed to actual expenditures) and revenue capacity (as opposed to actual revenue collections) for the determination of local governments’ “minimum expenditure budgets” and intergovernmental transfers (Bahl et al., 1998). In addition, if an adequate Treasury system is put in place

¹⁰⁴ A set of proposals for improving on this fund are presented in Morozov (1998). These include the canceling out or freezing of the majority of the federal earmarked programs, the reduction in their numbers, and the implementation of a smaller number of programs as closed-end matching grants.

it will be possible to downplay minimizing financial counterflows as an objective in the design of the system of regional-local fiscal relations. This will allow regions to focus on the main objective of reaching both vertical balance and horizontal balance in the allocation of regional resources.

Projects that provide technical assistance to regional government in the reform of intra-regional fiscal relations in certain pilot regions have the ability to demonstrate to other, more hesitant regions, that reform of intra-regional fiscal relations can be beneficial to both the regional government and the local governments. The federal government could accommodate the sharing of positive reform experiences by holding conferences and seminars on the issue for regional government official and by providing other regions with documentation on the success stories of regional reform. At the same time, any direct federal involvement in any comprehensive reforms in this area would raise constitutional as well as political concerns. Given the antagonistic position of many regions toward federal interference in regional-local relations, it may be well-advised for the federal government to limit its role in reforming regional-local transfers to educating regions about the severity of the disincentives, developing and providing legislative support for a *Subnational Budget Code*, promoting the voluntary use of formula-based transfer systems by the regions, and setting a good example regarding the responsible use of transfers.

CHAPTER 5

SUBNATIONAL BORROWING, DEBT AND FINANCIAL CONTROLS

Reform of the legal framework for subnational borrowing and debt forms the capstone of a solid system of intergovernmental fiscal relations in the Russian Federation. Responding to increasing budgetary pressure and a permissive regulatory framework, subnational governments over the transition period have increasingly resorted to borrowing and other types of deficit financing to maintain their levels of expenditure. In more recent years, federal authorities have become increasingly concerned about the dangers to national economic stability and the lack of responsible fiscal management arising from the permissive approach to subnational borrowing. As a result of these concerns, the Russian government has started to take measures to limit the borrowing power of subnational governments.

In this chapter, we first discuss the legal framework for subnational borrowing in Russia during the transition. Second, we present an analysis of the trends in subnational deficit finance and debt levels. Finally, we discuss the pending policy agenda for the reform of subnational borrowing. The three keys to a successful subnational deficit control are imposing legislative limits on borrowing, instituting bankruptcy and financial emergency controls for subnational governments and addressing the underlying fiscal imbalances that are at the root of the problem.

V.1 Evolution of the Legal Framework for Borrowing

During Soviet times, subnational budget resources were fine-tuned to provide sufficient resources to finance a negotiated minimum expenditure budget. As a result, subnational governments did not run deficits and they did not borrow, except from the Ministry of Finance for bridge financing purposes. These loans were supposed to be repaid before the end of the fiscal year, and as a rule they were. The early transition period saw a continuation of the traditions of the previous regime with regard to borrowing.

Starting in 1993, two basic pieces of legislation were introduced that provided for a much more permissive framework for subnational borrowing. The *Law on the Basis of Budget Rights and Rights in the Formulation and Execution of Extra-budgetary Funds* of 1993 and the *Law on the General Principles of Organization of Local Government in the Russian Federation* of 1995 granted subnational governments the right to borrow with very few restrictions. In particular, no explicit limits were imposed and subnational governments were allowed to borrow for all purposes, including for the financing of current expenditures. These rights were immediately put to use by many subnational governments.

In more recent years, concerns about the lack of responsible fiscal management at the subnational level and its impact on national economic stability have caused the Russian government to reverse its

course. More recent legislation and decrees have been trying to reign in the borrowing power of subnational governments. The *Law on the Securities Market* of 1996 required federal authorization and imposed registration disclosure requirements for bonds issued by subnational governments to be publicly traded securities. More recently, the *Law on the Financial Foundations of Local Government in the Russian Federation* of September 1997, restricted the amount that local governments may borrow to 15 percent of budget expenditures. This law included several other important restrictions: bonds may be issued only for investment purposes (as opposed to funding for current expenditures); municipally-owned banks are banned in order to avoid the moral hazard of joint borrowing and lending functions; and local bonds are not guaranteed by the federal government. However, the *Law on the Financial Foundations* applies only to local governments, and not to regional governments.

The new *Budget Code* approved in 1998 limits the budget deficits of regional governments to 5 percent of budget revenues (before transfers and loans) and the budget deficits of local governments to 3 percent of budget revenues (before transfers and loans). The overall level of debt for both regional and local governments is limited by requiring that expenditures for debt service in any year do not exceed 15 percent of budget expenditures. Failure to comply with these limits can result in a budget audit or in the assumption of control over budget execution by the upper-level government. The *Budget Code* further restricts the purpose of subnational borrowing to capital investment and seems to grant external borrowing privileges only to the federal government.¹⁰⁵

V.2 *Analysis of Subnational Deficits and Debts*¹⁰⁶

The balance of the trends over the past six years in expenditures, revenues and transfers at the subnational level has been toward sharp increases in subnational budget deficits. Although there are several ways to measure budgetary balance, any of these measures leads to the same conclusion of growing budget deficits at the subnational government level and the beginning of a noticeable accumulation of debt.

Subnational Deficits and Debt Levels

Over the transition period, the consolidated subnational government budget went from a surplus (after transfers and budget loans) of 1.45 percent of GDP in 1992 to a deficit (after transfers and budget loans) of 1.24 percent of GDP in 1997 (Table 45). If budget loans between governments are included as

¹⁰⁵ A series of presidential decrees in 1997 and 1998 authorized a small number of governments to issue Eurobonds. These decrees had imposed borrowing limits similar to those in the *Budget Code*; they required registration with the Ministry of Finance and imposed disclosure rules for the subnational finances. Freinkman et. al. (1998) reports that by the end of 1997, 12 regional governments had issued Eurobonds and many more were preparing to do so.

¹⁰⁶ Freinkman et. al. (1998) contains a comprehensive review of borrowing issues at the subnational level. This section draws on this study.

a means of deficit finance (as opposed to counting them as a type of transfer), the consolidated subnational budget deficit (after transfers) evolved from a surplus of 1.13 percent of GDP in 1992 to a deficit of 1.24 percent of GDP by 1997. The consolidated subnational budget deficit, of course, increases when measured before transfers. As reported in Table 45, the subnational surplus before transfers and budget loans was only 0.04 percent of GDP in 1992 while this deficit reached 3.10 percent of GDP in 1997.

The true size of the deficit for subnational governments is understated in Table 45. As discussed below, not all types of subnational debt are reported in the executed budget accounts. Non-conventional means of financing such as arrears or the use of extra-budgetary funds are not included in the reported deficits. Neither are liabilities for loan guarantees to municipal enterprises or suppliers reported in the executed budget deficit. When both reported and unreported debts of subnational governments are considered (excluding loans by the federal government), the total accumulated amount of subnational debt is estimated to have reached approximately 6 percent of GDP by early 1998 (Freinkman et. al., 1998). Of the subnational debt, most is accumulated at the regional level; the municipal share of the consolidated subnational debt is estimated to be around 20 percent.

At 6 percent of GDP the level of indebtedness of subnational governments should not be considered high. In fact, it looks quite favorable by international standards in other federal systems. (Table 46). Instead, the concern with subnational borrowing in Russia is caused by the characteristics of the debt (high interest costs and short maturities), the purpose of the debt (often used to finance current expenditures), and the deteriorating fiscal situation and the growing inability of subnational governments to service this debt (due to stagnant revenues and persistent budget arrears). Also, subnational debt levels have recently increased very fast (70 percent in 1997). But, these rapid percentage increases seem to be as much the result of the increase in borrowing as the initial low level of indebtedness.¹⁰⁷

How Are Subnational Deficits Financed?

Subnational governments have found multiple ways to finance their budget deficits. These have included both traditional and less conventional methods of financing. The latter do not show up in the budget accounts. Here are the main types of financing that have been used:

Budget Loans. Traditionally, the Ministry of Finance lent funds to regional governments for different purposes, but mainly to address short-term liquidity problems. The level of federal budget loans provided to subnational governments tended to increase over the transition; what were initially mere loans increasingly got written off as transfers by the federal government as the fiscal position of regional

¹⁰⁷ In fact, the increased reliance on deficit finance by subnational governments is leveling off over time when expressed in real terms. The year-to-year change in the per capita consolidated subnational budgetary balance from 1993 to 1997 (before budget loans), expressed in thousands of 1995 rubles evolved in the following manner: Rb. -11.7 (1993), Rb. -121.0 (1994), Rb -68.8 (1995), Rb. -51.3 (1996) and Rb. -35.2 (1997).

governments deteriorated. As a result, “budget loans” are now commonly counted as a form of transfers. In fact, budget loans have provided subnational governments with a soft budget constraint, and thereby negatively affected the incentives for subnational governments to limit spending or increase revenues. Excessive provision of such loans to subnational governments may have contributed to a further deterioration of the federal financial position leading up to the collapse of the Ruble in August 1998. As mentioned in Chapter IV, in 1997 budget loans and credits from the federal government amounted to 0.75 percent of GDP. Since these loans are often forgiven, they are often not counted towards the size of the subnational debt.

Commercial Debt. By early 1998, the reported commercial debt of subnational governments (not including budget arrears, guarantees, and debts to the federal government) was the equivalent to 1.5% of GDP.

Commercial bank loans have been the predominant source of commercial deficit finance, especially since the use of *veksels* (see below) was prohibited in early 1997. Approximately one third of all the commercial debt of subnational governments is held in the form of loans. The most worrisome aspect of the market for commercial loans to subnational governments is that these transactions are often not transparent and are subject to abuses and corruption. These concerns are further aggravated by the fact that certain regions actually own commercial banks from which they may be borrowing.

The use of *bonds* to finance subnational deficits has also grown in importance over the transition period. Since their introduction in 1994, markets for municipal and regional bonds have evolved from scratch, largely mirroring the growth of the market for federal bonds and government securities. The pioneer in the domestic market was St. Petersburg in 1994, followed by Moscow and Tatarstan. The use of bonds as a means of finance has increased rapidly; by the end of 1997 more than a quarter of the outstanding subnational commercial debt held was in the form of bonds. In total, around 70 regions have issued domestic bonds and a dozen or so have issued Eurobonds. All bond issues are supposed to be registered with the Ministry of Finance.

Due to the lenient regulatory requirements regarding their issue and circulation, *veksels* were an important form of subnational debt until 1996. *Veksels* are simply bills of exchange or promissory notes issued by regional governments instead of money in return for the provision of goods or services. The use of *veksels* as a means of finance was banned in early 1997 by the *Law on Bills of Exchange and Promissory Notes*. Despite this ban, it appears that many subnational governments have continued to issue promissory notes or have switched to alternative instruments which perform a similar function, such as *veksels* issued by commercial entities including public companies under control of subnational governments.

Budget Arrears and Other Unreported Methods of Deficit Finance. Budget deficits are calculated on a cash basis. As a result, the budget accounts do not reflect the accumulation of accrued but unpaid expenditures. These are arrears in wages to employees or payments to suppliers. Budget arrears of subnational governments have become an increasing source of deficit financing. They increased from 1 percent of GDP in 1994 to 2.6 percent of GDP in 1997. Due to shortcomings of the methods of debt accounting, budget arrears and several other alternative debt instruments do not appear to be reflected on

the budget. These include some forms of external borrowing, borrowing through extra-budgetary funds, and commercial financial instruments (other than *veksels*).

Why Do Regions Resort to Deficit Financing?

With very few exceptions, Russian regions have been subject to sharp decreases in available real resources during the transition period. The choice has been to either cut expenditures or run a deficit. Although most regions have done a combination of both, some regions have been more prone to running deficits and accumulating debt. Have some regions borrowed more because they were poorer, or because they have had higher fiscal needs or perhaps simply because they had greater access to financing? Some of these questions are explored in the regression analysis in Table 47. The dependent variable is “other sources of finance” which incorporates both budget loans from federal authorities as well as borrowing from any other reported source. The results, presented in Table 47, reveal a clear pattern. The results unambiguously show (with statistical significance) that in 1996 and 1997 regions with greater fiscal need, as measured by the shares of the population above and below working age, and regions with higher levels of cost of living, consistently relied more extensively on budget loans and borrowing. The negative coefficient for per capita GRP would indicate that poorer regions tend to borrow more; however, these coefficients are not statistically significant. The increase in the explanatory power of the regressions over time (from 0.20 in 1994 to 0.60 in 1997) also may be an indication that expenditure need factors are becoming a more binding determinant of regional budget deficits and the use of debt financing.

What Other Factors May Explain the Growth in Subnational Deficits?

There are several other potential explanations for the continued growth of subnational deficits, most of which are related in one way or another to the theme of fiscal needs identified above.

Offloading by the federal government. A possible explanation for the increased subnational deficit is the shifting of expenditure responsibilities from the federal government to subnational governments. The trend of subnational government deficits during the transition stands in sharp contrast with that of the federal deficit, which fell from 21 percent of GDP in 1992 to 3.3 percent of GDP in 1997. Over the period from 1992-1997, federal expenditures declined from approximately 40 percent of GDP to 20 percent of GDP. However, this offloading took place mostly in the early years of transition (1992-1993) when in the aggregate subnational governments ran surpluses. The shifting of expenditure responsibilities continued after 1994 largely in the form of unfunded mandates.

Subnational governments may have lacked fiscal discipline. Regional governments have been blamed for increasingly resorting to budget loans and borrowing to finance budget expenditures that should have been reduced or cut altogether years ago. Continued high levels of subnational government spending on the “national economy” sector, which largely consist of subsidies on housing and public utilities, are the most egregious examples of this behavior. Subnational governments also have been blamed for not rationalizing their expenditures by not pursuing more cost effective options to deliver services such as

closing some facilities with excess capacity or contracting with the private sector for the delivery of some services. The lack of adaptation may be a reflection of perverse incentives transmitted through the budget process, such as the incentive to keep public facilities open to maximize budgetary allocations.

The system has not provided incentives to increase revenue collections. Poorly designed revenue sharing arrangements and gap-filling transfer schemes, especially at the regional-local level, have contributed to a lack of fiscal effort. Low tax effort at the local level has required higher intergovernmental transfers and potentially resulted in higher regional government deficits.

Lack of revenue autonomy and vertical fiscal imbalances. The ability of regions to act upon the growing deficit has been restricted by the lack of significant own source revenues. This raises the difficult question of the degree of vertical imbalance in Russia's fiscal federalism. Vertical fiscal balance exists when there is a broad correspondence between the expenditure responsibilities assigned to each level of government and the fiscal resources available at their discretion to carry out those responsibilities. While both revenue sharing and transfers can be used to redress vertical imbalances, both political accountability and economic efficiency require that regional and local governments have discretion over (some of) their sources of revenues, meaning taxes and fees which they can expend or contract according to their needs and desires. It appears that subnational governments in Russia have not been given sufficient latitude to collect their own revenues. Further increases in fiscal autonomy could allow regional and local governments to respond to increasing budget pressures by increasing revenue collections, thus giving them an alternative to increased deficit finance and expenditure cuts.

Has Excessive Subnational Borrowing Contributed to Macroeconomic Instability?

There has been a growing concern about the potential damage that irresponsible borrowing behavior by subnational governments can inflict on the fiscal stability of the country, if the federal government were to become the lender of last resort. Subnational government borrowing also crowds out other domestic borrowers which may impair economic growth, especially if borrowing by subnational governments is used to finance current expenditures.

And yet, at least on the surface, it has not been the borrowing by subnational governments but, to a large extent, federal government borrowing combined with the rapid accumulation of short term debt at very high interest rates that brought the financial crisis and ruble devaluation in August 1998. However, the question remains whether the federal government actually was forced to shoulder the subnational deficits through budget loans and whether it was the need to indirectly finance these subnational deficits that caused the federal government to borrow heavily, which ultimately brought about the financial crisis.¹⁰⁸ A different explanation is that the attempts of the federal government to transfer its deficit to subnational governments,

¹⁰⁸ For example, in 1997 the federal deficit could have been practically eliminated if the federal government had kept the funds transferred to subnational governments (Table 45). Naturally, the federal deficit could also have been eliminated by an equal-sized reduction in spending in any other area of federal government spending.

through offloading of responsibilities and expenditure mandates, were only partially successful. In the end the federal government still had to borrow to finance part of the subnational government expenditures through transfers and budget loans.

V.3 Pending Policy Agenda for the Reform of Subnational Borrowing

There are several basic approaches for bringing discipline and responsibility to subnational government borrowing. The first approach relies on financial markets to self-enforce prudent borrowing behavior by subnational governments. Excessive or irresponsible borrowing gets punished by higher borrowing costs and ultimately by the refusal of lenders to provide funds to irresponsible governments. This approach only works effectively if there are well developed capital markets and institutions, including disclosure of information, ratings agencies and bankruptcy laws. The relative simplicity and self-enforcing properties of the market approach make it a more attractive and ultimately a superior approach. However, at the present time, clearly the Russian market and institutions are not developed enough to make the capital market a viable alternative. A second approach relies on federal or central government legislation to impose limits on borrowing for subnational governments and on central or federal government agencies enforcing these limits. Countries with less well developed capital markets and institutions often rely on this second approach. In addition, a successful strategy to impose restraints on subnational borrowing requires instituting bankruptcy and financial emergency controls and addressing the fiscal imbalances that underlying the fiscal problems of subnational governments.

Imposing Legislative Limits on Borrowing

Given that a legislative approach to subnational government borrowing is the most desirable at the present time in Russia, two questions need to be asked. First, have appropriate limits been set on borrowing by regional and local governments? Second, have appropriate monitoring and enforcement mechanisms been put in place?

In response to the first question, it appears that the limits to the overall level of debt for regional and local governments imposed by the *Budget Code* are adequate. Limiting debt service expenditures to no more than 15 percent of annual expenditures is prudent and falls in line with international practices. Other aspects of the limits to subnational borrowing in the new *Budget Code* are more problematic and should be reconsidered.

For example, allowing subnational governments to borrow to finance all kinds of expenditures, in particular current expenditures, is poor financial management. Borrowing should be limited to capital investment expenditures. The economic rationale for borrowing is that future generations of taxpayers should contribute to paying for the use of infrastructure that also benefits them. Borrowing allows the smoothing out or matching of tax payments and users of public services. Clearly, this rationale disappears when borrowed funds are used to finance current expenditures. In this case, future generations of taxpayers are made responsible for the consumption of current generations of taxpayers. An additional aspect of

subnational borrowing that should be considered is the international dimension. The overriding objectives of national macroeconomic stability call for the close scrutiny and approval by federal authorities of any foreign borrowing by subnational governments. However, the outright prohibition of all forms of international borrowing may deprive responsible subnational governments of cheaper and more readily available funds for worthwhile and well thought out infrastructure investment projects.

In response to the second question, it is obvious that the effectiveness of any limits on subnational government borrowing will depend on the quality and effectiveness of the monitoring and enforcement of those limits by the federal authorities. The only enforcement tool incorporated in the *Budget Code* is the requirement that all bonds issued by regional and local governments be registered with the Ministry of Finance. This falls dramatically short of what will be needed to monitor and enforce the legislated borrowing limits. The federal government has announced plans to create a monitoring agency for subnational governments within the Ministry of Finance, but no details have been given on how this agency will operate and how limits will be enforced. Given the inability of federal authorities in the recent past to monitor and control subnational government activities, this is an issue that will require immediate attention and significant federal government resources.

Subnational Bankruptcy and Financial Emergency Controls ¹⁰⁹

Part of a comprehensive strategy to counteract irresponsible fiscal management at the subnational level is formed by the implementation of regional or municipal bankruptcy procedures in case regional or municipal governments are unable to pay their debts as they come due. In countries where such procedures have been implemented, municipal bankruptcy or insolvency laws provide the debtor government with some degree of protection from its creditors in order to develop a plan that allows the insolvent subnational government to resolve its debts through negotiated debt restructuring, reorganization and refinancing of its debts, in a way that treats the interests of the creditors with some measure of fairness. When a region or municipality seeks bankruptcy protection, its financial administration may be placed under court supervision to ensure implementation of an adequate debt adjustment plan.

A subnational government should be considered insolvent when it is "generally not paying its debts as they become due unless such debts are the subject of a bona fide dispute" or "unable to pay its debts as they become due." Failure to pay wages and salaries, to make pension payments, to pay contractors, or to meet debt service payments of principal or interest would make the government insolvent. Under this definition, a large number of regional and local governments in the Russian Federation would qualify for bankruptcy protection. At the same time, a region that is merely experiencing temporary financial difficulty should not be considered for bankruptcy protection.

The intention of a subnational bankruptcy procedure would be to compel subnational government to engage in responsible fiscal behavior. For those subnational governments that are unable to remain

¹⁰⁹ This section draws on Mikesell (1998b), who presents a review of subnational government bankruptcy, default, and fiscal crises in the United States.

solvent, bankruptcy provides "breathing room" to make things right and to allow the government unit to be restored to financial health. Unlike bankruptcy legislation for businesses and individuals, bankruptcy procedures for subnational governments should not provide for liquidation of the assets of the municipality to satisfy the claims of creditors. Such a liquidation or dissolution would leave the citizenry without a local or regional government, which would clearly be unacceptable. Instead, reorganization of regional or municipal debts could be accomplished either by extending debt maturities, reducing the amount of principal or interest, or refinancing the debt by obtaining a new loan. During the reorganization, bondholders are typically considered superior creditors, so debt service will ordinarily flow on schedule; however, other contractual obligations may not be met. For instance, wages and salaries may have to be reduced from their previously agreed-to levels in order for the regional or local government to regain its financial health.

Regional or municipal bankruptcy is a drastic measure that should only be used in the most egregious cases of fiscal mismanagement. An alternative to bankruptcy that would avoid court involvement is the implementation of emergency financial management controls. In this case, a superior-level government intervenes with extraordinary controls to constrain the financial and economic damage caused by mismanagement of a regional or local government and prevents a bankruptcy filing. For example, in the United States twenty states have laws for provision of state assistance (and control) for municipalities in financial distress. Although each state's approach has its own features, the general objectives of such a program are:

- C To preserve and protect the fiscal solvency of local governmental entities.
- C To assist local governmental entities in providing essential services without interruption and in meeting their financial obligations.
- C To assist local governmental entities through the improvement of local financial management procedures.

The determination of a financial emergency is made based upon a set of objective criteria, for instance, when a subnational government fails to pay its obligations (wages, retirement benefits, debt service, etc.) or when it has insufficient reserves to cover a budget deficit for two successive years. When a financial emergency arises, the municipality or region is brought under close control of the superior-level government by establishing a board to oversee the operations of the locality and to provide technical assistance. The subnational government and the oversight board jointly develop a plan that provides payment for all debt obligations, pension payments, and all other mandatory payments while reducing expenditures by eliminating low-priority budget items.

Compared with the regional or municipal bankruptcy option, the state emergency boards involve far greater loss of local control and focus greater effort to reform and educate local officials regarding fiscally responsible practices. At the same time, emergency boards are empowered to change local priorities and to change fiscal decisions coming from the local political processes and may cause greater discomfort for local officials than would a bankruptcy.

The Need to Address Vertical and Horizontal Fiscal Imbalances.

A final observation regarding subnational deficits in the Russian Federation is that these deficits will not disappear without policies that address the existence of vertical and horizontal fiscal imbalances in the Russian Federation. Funding pressures are likely to continue in the medium term at all levels of government. There is therefore a need to reexamine the balance of expenditure needs and available resources at different levels of government. This examination should provide some basis for reorienting expenditures toward priority goals and highlight the need to increase the efficiency of public expenditures at all levels of government. Although substantial progress has been made in correcting the vertical fiscal imbalance, there is a continued need for expanding the revenue autonomy of subnational governments. Giving subnational governments the capacity to impose taxes, if so desired, is the most effective, if not the only, way to address these vertical imbalances. The fact that those regions with greater expenditure needs are more likely to use deficit financing is also a clear indication of significant horizontal imbalances and, in particular, that the transfer system has failed to address these needs. This risks the possibility that critical subnational programs in areas such as health and education may go unfunded. A focus on vertical and horizontal imbalances will provide the necessary perspective of the “big picture” that has been missing in much of the reform process in the last five years.

CHAPTER VI IMPLEMENTING REFORM

This chapter focuses on the process through which reforms in intergovernmental fiscal relations should be implemented, discussing several important issues which need to be considered by the Russian government in the formulation and implementation of the reforms. These are (i) piece-meal versus unified strategies for reform, (ii) the asymmetric versus uniform treatment of subnational governments, (iii) the compliance with, and enforcement of, federal legislation among subnational governments, (iv) the improvement of communications between the federal and regional governments, and (v) the consideration of the appropriate form that federalism should take in Russia (in particular, deciding how much the federal government should intervene and regulate regional-local relations).

VI.1 Piece-meal versus Unified Reform Strategy

One main feature of the Russian government's approach to the reform in intergovernmental fiscal relations during the transition has been its piece-meal nature. Put in a different way, the Russian government has lacked a coherent and unified strategy for the reform. A unified strategy would have required an explicit statement, balance, and implementation of the government's key objectives underpinning the decentralization policy. In order to reach an explicit and comprehensive reform strategy, the government would have to address the extent and nature of federalism that it seeks to achieve, the desirable degree of equalization in the distribution of fiscal resources across regions, the promotion of a more efficient use of budgetary resources, the creation of incentives for revenue mobilization and the preservation of fiscal discipline and responsibility among subnational governments.

The difficulties involved in reaching a national consensus on the general objectives of fiscal decentralization policy may, it is clear now with hindsight, help to explain the absence of a unified and explicit reform strategy. The process of defining an overall strategy for reform, which requires the weighting of the different objectives to be pursued in this reform, will likely continue to be difficult and slow. The views of the President's Administration and the Ministry of Finance on the issues surrounding decentralization tend to differ considerably from those held at the State Duma and especially at the Federation Council. There is also a significant diversity of interests and values held at the Federation Council among the "have" and "have not" regions.

As mentioned earlier in this document, the Russian government's current strategy for reform of intergovernmental relations is outlined in the "*Concept of Reform of Inter-Governmental Fiscal Relations*" drafted in 1998 by the Working Group on Intergovernmental Fiscal Relations. Even though this document has gone through many versions, every one of them adopting a more comprehensive approach than its predecessor, the most recent version of the *Concept* still falls short of delivering a unified

reform strategy. In particular, policy issues and recommendations in the *Concept* document are discussed in isolation with no explicit links to other components. This document does not, furthermore, make any attempt to quantify the impact of the individual elements of the reform agenda nor how they would affect the current vertical and horizontal balances in intergovernmental fiscal relations.

The legacy of the piecemeal reform strategy during the transition is reflected in a legal framework for intergovernmental fiscal relations that is fragmented, incomplete, and often contradictory or inconsistent. In addition, some parts of the current legislation have never been implemented or have only been partially implemented because regions have simply refused to accept the provisions or because some of the regions have negotiated with the federal authorities to be exempted from the legislation. Consistent with the lack of unified reform strategy, the most conspicuous feature of the current legal framework for intergovernmental fiscal relation has been its ambiguity and the tendency to postpone addressing basic and fundamental questions.¹¹⁰

Addressing the wide array of current problems in intergovernmental fiscal relations all at once would be a difficult if not impossible task. Rather, what the government needs to consider is how to strengthen the “*Concept of Reform of Inter-Governmental Fiscal Relations*” in light of a comprehensive and unified strategy for reform. As part of this revision process the government should undertake the difficult task of systematically reviewing all the existing laws and, whenever necessary, to draft amendments to ensure that all relevant legislation conforms to the government’s overall strategy and objectives. One way to make the revision of the reform strategy more meaningful and to improve the chances of success for these reforms is to get representatives from all three levels of government directly involved in the definition and implementation of the strategy. Reforms that are imposed in a top-down process are certain to be received with suspicion and hostility by subnational governments; this is true anywhere in the world, but especially in Russia. Regional and local governments should be particularly instrumental in the reform of regional-local relations, such as the development of a *Subnational Budget Code*. In this arena, the federal government should play more of a coordinating role rather than relying on its executive power. Although the Federation Council has regional representations and interest at its core, this body is not likely to adequately represent and articulate the views and interests of local governments. A new institutional vehicle might have to be considered, which could benefit from input from both regional and local governments in the formulation and implementation of comprehensive reform of intergovernmental fiscal relations.

VI.2 Uniform versus Asymmetric Federalism and Addressing Fiscal Disparities

Asymmetric federalism, the non-uniform treatment and standing of the subjects of the Federation, may have been unavoidable given the historical precedents inherited by the Russian Federation and the need to accommodate the demands for autonomy from ethnic regions. Asymmetric federalism may also

¹¹⁰This is best illustrated in the few articles in the 1993 Constitution dedicated to intergovernmental relations. These articles are ambiguous regarding the division of powers between the federal and regional governments (Articles 71 and 72) and the right to local self-government (Articles 12 and 132).

have been justified by the need to deal with regions in significantly different circumstances and with significantly differing abilities to implement policies and programs. But asymmetric federalism has brought with it important risks. Most importantly, asymmetric federalism has undermined national solidarity and imposed a system that lacks “unity of interest” (Igudin, 1998).

As discussed in Chapter I, during much of the transition period the pressure at the federal level has been for granting new privileges to other regions or for expanding existing ones. However, more recently there has been a growing awareness at the federal level of the problems associated with the use of bilateral treaties. As a result, the 1998 budget asked for the reopening of all bilateral treaties to ensure that they accord with the provisions in the budget. There is no evidence that any of this has actually taken place. Similar plans for the reconsideration of all bilateral treaties have been proposed at different stages for the 1999 budget.

Even though the demands from ethnic regions for autonomy will continue to pose problems in the future, in the longer run the most difficult challenge to the reform of fiscal federalism in Russia will most likely come from the growing fiscal disparities among the regions. Economic and fiscal disparities among Russian regions were already significant at the time of independence. However, large amounts of resources were expended by the Soviet regime to equalize fiscal disparities among the regions and to keep afloat unviable regional economies in remote areas of the country. The disparities that existed before independence have grown significantly over the transition period. The lack of market development outside a few geographical areas, the lack of labor mobility, and the absence of adequate and universally available social services has led to a situation in which it seems that these economic and fiscal disparities would need to be addressed by non-market means. However, the government’s failure so far to address this issue squarely has created increasing political tensions (Polishchuk 1996).

There are reasons for this policy of neglect. The growing inequality in the distribution of tax bases has made the federal government more vulnerable to political pressures from richer regions which increasingly have opposed the idea of higher federal revenues to redistribute to the poorer regions. At the same time, the plight of the worse-off regions has deteriorated because their troubles have been increasingly perceived at the federal level as being self-inflicted due to poor fiscal and economic management.

The growing economic and fiscal disparities among regions have led to a pronounced divergence of interest among the regions and to a lack of consensus in national policies. This has put the federal government in the crucible of either engaging in more redistribution among the regions or possibly achieving faster, but geographically uneven, economic growth. In the first paradigm, the federal government would have to tax resources away from those regions that are performing better economically. Under the second paradigm, equalization (if it happens at all) would come from migration and other market adjustment mechanisms. There is no evidence that the government has chosen explicitly between these two paradigms, but by default the current direction in federal policies seems better represented by the second paradigm.¹¹¹

¹¹¹ However, there are still important restrictions to the free flow of people within the country. Although declared unconstitutional, several regions (including Moscow City) still require the *propiska*, an internal passport permit to reside within its borders.

The current plans at the federal level would appear to include implementation of further reductions in the funds available for equalization. In addition, the federal government is proposing a “dual” regime by which those regions that are most dependent on federal transfers would be forced to institute reforms of regional budgeting practices while other regions might even have to completely relinquish their budget powers to the federal authorities.¹¹² These policies may be the most viable politically, but it is questionable whether they will sufficiently address the problems of poorer regions, such as the ability of these regions to provide adequate levels of basic services, including health and education. It also appears that these federal policies do not distinguish sufficiently between poor fiscal management and a poor economic base. These two phenomena may be highly correlated, but it is in the interest of the federal authorities to carefully differentiate between them and over time to improve the fiscal management of regions that are both poorly managed as well as poor. The question needs to be raised whether the proposed policies will create a permanent underclass among regions which will be dependent on federal support and controls and add fuel to fires raised by the practice of asymmetric federalism over the past seven years. Although some asymmetry in intergovernmental fiscal relations has to be accepted as unavoidable in the Russian Federation, future reforms of the system of intergovernmental relations should aim to approach federal-regional relations in a uniform way when possible or, at least to avoid an expansion of the asymmetry already contained in the system. Further asymmetry would only serve to push the Russian Federation further down the path of divisiveness.

VI.3 Compliance with the Federal Laws by the Regions

Fiscal federalism in Russia has been complicated by the open hostility between the federal government and some of the regions. This problem was more severe in the earlier years of the transition, but the issue has not disappeared. Contentious relations in combination with the absence of an institutional mechanism to monitor subnational governments have seriously inhibited the ability of federal authorities to enforce federal laws throughout the national territory. Perhaps the most egregious form of lack of compliance has been the decision by some regions not to remit revenues from federal taxes to the federal government. However, the lack of compliance with federal laws by the regions has taken many other forms as well.

In recent years there have been more open attempts by the federal government to enforce federal laws. The *Law on the 1996 Federal Budget* contains a number of measures to punish those regions breaching federal legislation on issues of taxation and budgetary matters. These measures included the suspension of funding for all federal programs being implemented in the region; termination of all kinds of transfers, loans and credits; termination of issuance of export licenses; suspension of centralized product delivery from government sources; and the retrenchment of credit and cash supplies to the regions by the Central Bank of Russia. However, it is hard to tell how many, if any, of these measures have actually been

¹¹²There have been calls for establishing direct federal control for budget formulation and execution in those regions that are especially dependent on federal monies, for example those for which FFSR allocations represent more than 50 percent of their budgets (Ingushetia, Dagestan, Tuva, Adygeya, Karachyevo-Cherkeskaya and Kabardino-Balkarskaya and Marii-El) (IEPT, 1998).

implemented. What is known is that the Ministry of Finance did *de facto* transfer an equivalent amount in expenditure responsibilities for federal programs to those regions where unauthorized shares of revenue collections were held.

In addition, the federal government has opted for more direct “bribing” to bring regional governments in compliance with federal policies.¹¹³ During the first half of 1998, in accordance with a Presidential Decree of May 5, 1997, the Ministry of Finance signed agreements with most of the regions that had received budget loans to clear local wage arrears. According to these agreements, the federal government would forgive the budget loans providing the regions agreed to implement a set of federal policies which the federal government had heretofore not succeeded in establishing in the regions.¹¹⁴ To enforce these agreements, the federal government is threatening to reduce the amount of equalization transfers for any non-compliant region by an amount equal to the scheduled loan repayment by the region. The draft of the 1999 budget provides for a similar mechanism. The draft budget contains provisions that call for the withdrawal of equalization transfers and any other grants or loans to regions that fail to comply with a specific set of federal policies. However, some of the federal requirements, such as the elimination of all non-monetary forms of payments in regional budgets, are unlikely to be fulfilled, since more than half of all tax receipts by regional governments are non-cash payments. Making pronouncements that later can not be enforced has weakened the standing of federal authorities in the regions.

It is unclear what the final impact of the August 1998 ruble crisis will be on the relations between the federal and regional governments. Many regions openly defied federal authorities and legislation in a number of areas in the weeks following the crisis. Gaining the ability to enforce federal laws in the regions will continue to be a crucial element for a working system of intergovernmental fiscal relations. At one level this may require amending the Constitution and using the court system to prosecute regional violations of federal laws. On a day-to-day level, better compliance will require strengthening and reforming existing institutions, such as the State Tax Service, or the introduction of new ones, such as the Treasury function for the execution of the federal budget. When, and if, the federal authorities get real control of the collected federal tax revenues (and how these funds are spent), half the battle would be won. Federal authorities also need to treat regional governments as partners; cooperation and consensus generally lead to much better regional compliance with federal laws than do conflict and forced imposition.

¹¹³ See: *Memorandum of the Government of the Russian Federation and the Central Bank of the Russian Federation on Economic and Financial Stabilization Policies*, July 16, 1998. Since the Constitution does not provide for the possibility of restricting the powers of regional governments due to their financial status or fiscal performance, control of budget disbursements or even less direct controls can only be reached by agreement between the regions and the federal government. These agreements can only be reached by “bribing” the regional governments via transfers. This also means that federal control and enforcement is likely to be limited to poorer regions dependent on transfers.

¹¹⁴ These policies included the discontinuation of the practice of tax offsets, the elimination of wage arrears, bringing subnational government pay scales in line with those of the federal government, and bringing cost recovery for housing and public utilities in line with federal standards.

VI.4 Communications Between Federal and Regional Governments

An important feature of Russian fiscal federalism has been the lack of communication and exchange between the federal and regional authorities on fiscal issues. International practices differ greatly with respect to this issue, ranging from the practice of "cooperative federalism" in Germany whereby federal and subnational fiscal strategies and targets are coordinated; to the Premiers' Conferences in Australia, Canada and New Zealand which provide for an exchange of views, but are more informational in nature; to the complete lack of coordination between the fiscal strategies of different levels of government, such as is the case in the United States.

Given the nature of Russia's federalism and the history of intergovernmental fiscal relations during the transition, it would appear that many of the current conflicts and the lack of smoothness in intergovernmental operations could be helped by increased communications between the federal and subnational levels of government. This could be accomplished, for example, by replicating some of the features of the approach followed by Australia or Canada. The Ministry of Finance could host a formal annual conference on intergovernmental fiscal relations to which finance directors of all 89 regions would be invited. Without binding powers, this conference should have the objective of allowing for open communications and exchange of information and priorities between the Federal Ministry of Finance and their counterparts in the regions. As an alternative to the conference of regional finance directors (or in addition to it), this conference could involve the Prime Minister (or the President) and the governors of the 89 regions. On a more permanent basis, the Russian government could establish an advisory council on intergovernmental relations comprising representatives from all three levels of government, similar to the U.S. Advisory Commission on Intergovernmental Relations. Such a non-partisan advisory body could prove particularly useful in identifying programs that contain unfunded federal mandates and making policy recommendations to either eliminate, fund, or modify these programs.

In actuality, the Ministry of Finance has already held some annual conferences with the regions to discuss the rules for the distribution of the fund of support of the regions (FFSR). This annual conference could be formalized as part of the budget process and its scope expanded to cover not only equalization fund issues but also medium-term plans for revenue sharing and expenditure assignment, borrowing, and the medium-term budgetary strategies from all the regions. Part of this conference could also be used for sharing experiences among regions on regional-local relations issues.

VI.5 Determining the Form of Fiscal Federalism

There are significant differences between the *de jure* fiscal federalism in Russia and the system of fiscal federalism that is actually in place in the Russian Federation. This schism has left several important questions unanswered that could greatly affect the performance and efficiency of the system of intergovernmental fiscal relations. These questions include: How much autonomy should local governments have vis-a-vis regional governments? Should the federal government directly address some policy issues with local governments, thereby entirely bypassing regional governments? How much control can the federal government exert over regional governments in mandating certain regional government policies

toward local governments? These are fundamental questions concerning the nature of federalism in Russia. There is no universal model for a federalist structure of government. Federative countries around the world have answered those questions in many different ways, depending upon their history and political needs.

In Russia, the 1993 Constitution proclaims the independent right of local governments to manage their affairs separately from the sovereignty of the state, which includes both the federal government and the subjects of the federation or regional governments.¹¹⁵ In reality, local governments have been subject to regional dictates in funding and expenditure assignment matters, if not to the outright control of regional governments. Regional governments, for the most part, have been satisfied with these arrangements, or at the very least see them as a necessary evil given the current economic and financial conditions. From the viewpoint of many local governments, and also increasingly from the viewpoint of the federal government, regional governments have not done a good job in managing their fiscal relations with local governments. The question is whether or not (or to what extent) the federal government should intervene in structuring the fiscal relations between regional and local governments.

Recently the federal government has started to challenge the *status quo* in the relationships between regional and local governments. The first attempt to structure regional-local relationships came with Presidential Decree No. 685 in 1996 which mandates regional governments to implement minimum shares for tax revenues with local governments from January 1997.¹¹⁶ More recently, the *Law on Financial Foundations of Local Self-Government in the Russian Federation* of September 1997 was only passed by the State Duma and the Federation Council after several changes were made at the insistence of the Federation Council. This law proclaims a prohibition on unfunded mandates and prohibits the clawing back of revenues if local governments raise more revenues than anticipated in the budget plans. It also establishes minimum sharing rates for taxes with local governments, but only on average for all local governments within the region. Overall, the *Law on Financial Foundations* provides few actual constraints on the way in which regional governments deal with local governments. However, regional authorities have opposed these administrative reforms because of the precedent that it sets, which they fear will eventually result in regional loss of control over local governments. The significance of the *Law on Financial Foundations* is that the traditional vertical or hierarchical structure, in which local governments at the bottom respond exclusively to regional authorities, may be breaking up in favor of a system that separates (or at least regulates) the fiscal relationships between state authorities and local self-governments.

The challenge ahead is how best to structure these relationships. There is no obvious best answer to this complex issue. As pointed out above, international practice in this area covers the entire gamut of possibilities. Given the historical context and the lack of institutional development in many regions, a policy that would provide broad federal guidelines and parameters but still leave choice for the regions may be best suited to Russia at the present time. In this context, federal legislation could provide local governments

¹¹⁵ This principle was re-asserted in the *Law of Basic Principles of local Self-Government of August 1995*.

¹¹⁶ However, these minimum shares were so low (5 percent of total tax collections for the most important taxes) that the decree had little substantial effect.

with much more revenue autonomy and budgetary certainty than they have enjoyed until now. This seems to be the principle inspiring the recent legislation on these issues. However, in order to improve subnational budget practices the federal legislation will need to impose actual constraints on regional government behavior *vis-a-vis* local governments. That could best be accomplished through the enactment of a *Subnational Budget Code*.

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Table 1
Assignment of Expenditure Responsibilities in the Russian Federation in 1997

Expenditure	Federal	Regional	Local
Defense	100 percent (except military housing)	Military housing	---
Justice/internal security	100 percent	---	---
Foreign economic relations	National programs	Some regions maintain their own relations	---
Education	All university and research institute expenditures	All technical and vocational schools	Wages, operation constructions, and maintenance of all primary and secondary schools
Culture and parks	National museums National theaters	Regional museums	---
Health	Medical research institutes	Tertiary hospitals, psychiatric hospitals, veteran hospitals, diagnostic centers, and special service hospitals (cardiology, etc.)	Secondary hospitals Primary health clinics Medicines
Roads	Construction and maintenance of federal roads	Construction and maintenance of oblast roads	Maintenance of rayon and city roads
Public transportation	--	Most public transportation facilities	Some transportation facilities, including subway systems
Fire protection	---	Most fire protection services	Voluntary, military, and enterprise services possible at this level
Libraries	Special libraries (for example, the Lenin library)	Special library services	Most local library services
Police services	National militia	Traffic police and National militia	Local security police
Sanitation (garbage collection)	---	---	Garbage Collection
Sewage	---	Infrastructure capital investment	Most of the operational expenditures
Public utilities (gas, electricity, and water)	---	Subsidies to enterprises	Subsidies to enterprises
Housing	---	Part of housing construction and subsidies	Part of housing construction, subsidies, and maintenance
Price subsidies	Part of food and medicine subsidies	---	Fuels, mass transport; food (bread, milk); medicines
Welfare compensation	Part central government responsibility	Part oblast government responsibility	Managing programs funded by upper-level governments
Environment	National environmental issues	Local environmental problems, (for example, the preservation of forests)	---
Public enterprises	Federal investment programs, subsidized credits, subsidies to particular sectors (mining, agriculture, tax benefits)	Subsidies to particular sectors (agriculture), investments, grants, tax benefits	Various explicit and implicit subsidies and benefits

SOURCE: Updated from Martinez-Vazquez (1994)

Table 2
Distribution of Expenditures Between the Levels of the Government, 1992-1997
(as percent of GDP)

	1992	1993	1994	1995	1996	1997
Federal Budget	39.6	23.8	23.4	18.4	19.8	15.7
Consolidated Region Budget	12.3	16.1	18.2	15.1	15.6	17.0
Regional Budgets	6.0	8.0	9.7	7.8	7.8	--
Local Budgets	6.3	8.1	8.5	7.3	7.8	--
Total	51.9	39.9	41.6	33.5	35.4	32.7

Note: Transfers to other levels of government may result in double counting; amounts may not add up due to rounding.

Source: Freinkman et al. (1998) and Ministry of Finance.

Table 3
 Distribution of Expenditures Between the Levels of the Government, 1992-1997
 (as percent of total)

	Expenditures					
	1992	1993	1994	1995	1996	1997
Federal Budget	76.3	59.6	56.3	54.9	56.0	48.0
Consolidated Region Budget	23.7	40.4	43.7	45.1	44.0	52.0
Regional Budgets	11.6	20.1	23.3	23.3	22.0	--
Local Budgets	12.1	20.3	20.4	21.8	22.0	--
Total	100.0	100.0	100.0	100.0	100.0	100.0

Note: Transfers to other levels of government may result in double counting; amounts may not add up due to rounding.

Source: Freinkman et al. (1998) and Ministry of Finance.

Table 4
Distribution of Expenditures by Function Between the Levels of Government, 1992-1997

	1992	1993	1994	1995	1996	1997
Administration And Justice	100.0	100.0	100.0	100.0	100.0	100.0
Federal Budget	80.5	79.6	81.4	63.1	63.7	62.0
Consolidated Subnational Budget	19.5	20.4	18.6	36.9	36.3	38.0
Regional Budgets	5.5	6.1	6.2	--	19.0	--
Local Budgets	14.0	14.3	12.4	--	17.3	--
Defense	100.0	100.0	100.0	100.0	100.0	100.0
Federal Budget	100.0	100.0	100.0	100.0	100.0	100.0
Consolidated Subnational Budget	0.0	0.0	0.0	0.0	0.0	0.0
Regional Budgets	0.0	0.0	0.0	0.0	0.0	0.0
Local Budgets	0.0	0.0	0.0	0.0	0.0	0.0
National Economy	100.0	100.0	100.0	100.0	100.0	100.0
Federal Budget	80.8	48.6	30.4	26.3	27.5	24.0
Consolidated Subnational Budget	19.2	51.4	69.6	73.7	72.5	76.0
Regional Budgets	8.7	24.6	34.8	35.4	32.4	--
Local Budgets	10.5	26.8	34.9	38.2	40.1	--
Education	100.0	100.0	100.0	100.0	100.0	100.0
Federal Budget	33.8	19.5	19.9	15.9	14.5	13.2
Consolidated Subnational Budget	66.2	80.5	80.1	84.1	85.5	86.8
Regional Budgets	14.5	18.9	19.1	19.7	18.0	--
Local Budgets	51.8	61.6	61.0	64.4	67.5	--
Culture and Mass Media	100.0	100.0	100.0	100.0	100.0	100.0
Federal Budget	51.2	34.8	39.6	31.6	34.7	16.5
Consolidated Subnational Budget	48.8	65.2	60.4	68.4	65.3	83.5
Regional Budgets	21.2	30.2	28.9	30.8	29.3	--
Local Budgets	27.6	35.0	31.5	37.6	36.0	--
Health and Phys. Ed.	100.0	100.0	100.0	100.0	100.0	100.0
Federal Budget	11.3	10.5	11.8	9.9	10.2	11.8
Consolidated Subnational Budget	88.7	89.5	88.2	90.1	89.8	88.2
Regional Budgets	28.5	30.2	33.4	33.4	33.1	--
Local Budgets	60.2	59.3	54.8	56.7	56.8	--
Social Protection	100.0	100.0	100.0	100.0	100.0	100.0
Federal Budget	71.8	52.0	50.3	18.5	31.2	41.3
Consolidated Subnational Budget	28.2	48.0	49.7	81.5	68.8	58.7
Regional Budgets	20.4	34.9	34.9	31.1	26.8	--
Local Budgets	7.8	13.2	14.8	50.3	42.0	--

Source: Freinkman et al. (1998) and Ministry of Finance.

Table 5
Average Regional Expenditures by Category, as Percent of Total Regional Expenditures, 1994-1997
(Coefficient of Variation in Parentheses)

	National Economy	<i>of which:</i> <i>Housing and Utilities</i>	<i>of which:</i> <i>Agriculture</i>	<i>of which:</i> <i>Transportation</i>	Education	Health and Physical Ed.	Social Protection	Other
1994	36.0 (0.17)	19.9 (0.35)	7.1 (0.54)	2.9 (0.57)	21.7 (0.17)	15.8 (0.17)	6.6 (0.32)	19.0 (0.25)
1995	34.8 (0.25)	20.4 (0.34)	6.4 (0.60)	3.9 (0.56)	22.6 (0.22)	16.1 (0.19)	8.1 (0.30)	18.3 (0.49)
1996	41.2 (0.24)	21.9 (0.38)	5.4 (0.66)	4.1 (1.20)	24.0 (0.23)	15.7 (0.20)	8.9 (0.34)	10.3 (0.18)
1997	32.2 (0.25)	20.9 (0.34)	4.9 (0.62)	3.3 (0.65)	24.4 (0.21)	15.2 (0.19)	7.9 (0.36)	20.4 (0.29)

Source: Authors' calculations based on data from the Ministry of Finance.

Table 6
Evaluation of Composition of Expenditures for Subnational Governments in Real Terms, 1992-1997

	In Real Terms: Per Capita 1995 Rubles						In Real Terms: Index (1994=100)					
	1992	1993	1994	1995	1996	1997	1992	1993	1994	1995	1996	1997
Total Expenditures	1,671.6	2,017.2	2,023.7	1,625.8	1,590.3	1,761.3	82.6	99.7	100.0	80.3	78.6	87.0
National Economy	559.4	662.7	821.7	664.4	735.5	648.9	68.1	80.7	100.0	80.9	89.5	79.0
<i>o/w Housing</i>	--	--	529.9	407.1	409.5	414.9	--	--	100.0	76.8	77.3	78.3
<i>o/w Agriculture</i>	--	--	120.1	97.0	78.5	76.5	--	--	100.0	80.7	65.3	63.7
<i>o/w Transport</i>	--	--	57.6	84.7	74.2	77.2	--	--	100.0	147.2	128.9	134.2
Education	261.2	313.4	401.2	322.0	335.8	372.5	65.1	78.1	100.0	80.3	83.7	92.8
Health and Phys. Ed.	241.6	266.8	320.1	250.2	242.0	252.7	75.5	83.3	100.0	78.2	75.6	78.9
Social Protection	33.5	34.0	120.3	114.8	125.1	128.3	27.8	28.2	100.0	95.4	104.1	106.7

Source: Authors' calculations based on data from the Ministry of Finance.

Table 7
Regional Economic Disparities in the Russian Federation:
Per Capita Gross Regional Product , Selected Years from 1992-1996
(in thousands of Rubles)

	Mean	Coefficient of Variation	Minimum	Maximum
1992	124.7	0.87	24.6	786.0
1994	3,725.3	0.74	618.1	20,892.4
1995	9,487.9	0.84	1,881.9	59,004.5
1996	13,554.6	1.04	2,628.0	108,443.5

Source: Authors' calculations based on data from Goskomstat.

Table 8
 Measures of Horizontal Fiscal Imbalance in the Russian Federation:
 Per Capita Consolidated Regional Expenditures, 1992-1997
 (in thousands of Rubles)

	Mean	Coefficient of Variation	Minimum	Maximum
1992	18.9	0.83	7.2	85.15
1993	219.7	0.78	100.7	1,189.2
1994	959.7	1.19	359.8	8,000.7
1995	1,918.2	1.01	720.2	13,004.3
1996	2,861.5	1.06	1,050.3	16,521.1
1997	3,762.6	1.17	1,336.7	30,543.5

Source: Authors' calculations based on data from the Ministry of Finance.

Table 9
 Level of Equalization at Different Stages of Revenue Assignment:
 Coefficient of Variation of Cumulative Per Capita Allocation, 1992-1997

	Total Revenue Collections ¹	Own, Shared and Other Regional Revenues ²	Revenues after FFSR ³	Revenues after all Transfers and Settlements ⁴	Regional Expenditures
1992	--	0.88	0.88	0.77	0.83
1993	0.68	0.67	0.67	0.79	0.78
1994	0.85	0.89	0.92	1.14	1.19
1995	1.12	0.86	0.89	0.94	1.01
1996	1.33	1.11	1.03	1.00	1.05
1997	1.61	1.39	1.22	1.18	1.17

¹ Defined as all shared and own source tax collections, including the federal share of shared revenues.

² Excluding transfers and other source of financing.

³ The FFSR was introduced in 1994; in earlier years equalization was achieved through variable sharing rates and other equalizing transfers.

⁴ Excluding budget loans.

Source: Authors' calculations based on data from the Ministry of Finance.

Table 10
Regional Socio-Economic and Demographic Variables: Descriptive Statistics

	Cost of Living Index	Pct. Pop. Younger Work Age	Pct. Pop. Older Work Age	Pct. Pop. in Poverty (1995)
Average	113.3	24.0	18.5	30.64
Coef. of Variation	0.44	0.16	0.29	0.38
Minimum	68.0	18.2	4.4	16.1
Maximum	357.0	35.5	27.1	73.2

Note: Data are for 1996 unless noted otherwise.

Table 11
Determinants of Per Capita Expenditures¹: 1994-1997

	Intercept	Per Capita GRP	Cost of Living Index	Pct. Pop. Younger Work Age	Pct. Pop. Older Work Age	Pct. Pop. in Poverty	Per Capita Transfers	Tax Effort ²	R ²
1994	-2,516.2	117.9	6.52	37.5	29.0	-1.1	0.84	30.2	0.98
1995	-2,115.7	81.3	17.8	11.6	-7.0	-5.0	0.80	63.4	0.91
1996	-4,607.7	131.0	13.2	53.7	64.1	-9.8	1.86	46.8	0.97
1997	-13,088.3	215.9	28.1	202.4	201.4	-0.0	0.97	44.8	0.95

¹ Bold indicates statistical significance at the 5 percent level.

² Tax effort is defined as total collections as a percent of gross regional product (GRP).

Source: Authors' calculations based on data from the Ministry of Finance.

Table 12
Determinants of Per Capita Expenditures on National Economy¹, 1994-1997

	Intercept	Regional Collections	FFSR Transfers	Other Transfers ²	Other Sources of Finance ²	Cost of Living Index	Pct. Pop. Younger Work Age	Pct. Pop. Older Work Age	Pct. Pop. in Poverty	R ²
1994	121.03	0.44	0.63	0.26	0.77	-0.31	-4.18	-0.33	-0.32	0.98
1995	-612.00	0.45	0.08	0.66	0.19	1.37	4.35	16.27	-0.05	0.93
1996	798.41	0.62	0.58	1.18	0.36	-5.34	-28.57	-8.43	4.26	0.98
1997	2,129.58	0.52	0.40	0.61	0.52	-8.61	-56.40	-27.22	4.50	0.97

¹ Bold indicates statistical significance at the 5 percent level.

² Other transfers include mutual settlements, subventions and other minor transfers, but exclude budget loans. Other sources of financing is defined as the difference between expenditures and all revenues and transfers.

Source: Authors' calculations based on data from the Ministry of Finance.

Table 13
Determinants of Per Capita Expenditures on Housing and Public Utilities ¹, 1994-1997

	Intercept	Regional Collections	FFSR Transfers	Other Transfers ²	Other Sources of Finance ²	Cost of Living Index	Pct. Pop. Younger Work Age	Pct. Pop. Older Work Age	Pct. Pop. in Poverty	R ²
1994	447.14	0.31	0.60	0.22	0.51	-1.11	-12.88	-5.35	0.16	0.94
1995	550.64	0.23	0.32	0.20	0.06	0.24	-23.32	-4.44	0.86	0.86
1996	2,495.37	0.23	0.65	0.98	0.16	-4.98	-57.79	-38.97	-2.68	0.87
1997	4,985.91	0.14	0.39	-0.11	0.36	-5.64	-100.96	-90.99	-5.69	0.86

¹ Bold indicates statistical significance at the 5 percent level.

² Other transfers include mutual settlements, subventions and other minor transfers, but exclude budget loans. Other sources of financing is defined as the difference between expenditures and all revenues and transfers.

Source: Authors' calculations based on data from the Ministry of Finance.

Table 14
Determinants of Per Capita Expenditures on Education¹, 1994-1997

	Intercept	Regional Collections	FFSR Transfers	Other Transfers ²	Other Sources of Finance ²	Cost of Living Index	Pct. Pop. Younger Work Age	Pct. Pop. Older Work Age	Pct. Pop. in Poverty	R ²
1994	-318.08	0.15	0.14	0.17	0.06	0.93	8.47	4.20	-0.54	0.99
1995	-510.39	0.13	0.26	-0.05	-0.05	3.04	12.76	5.18	-2.17	0.96
1996	36.14	0.10	0.17	-0.11	0.30	3.53	3.97	-6.64	-3.19	0.94
1997	-723.65	0.08	0.15	-0.07	0.16	7.37	23.94	0.43	-6.23	0.94

¹ Bold indicates statistical significance at the 5 percent level.

² Other transfers include mutual settlements, subventions and other minor transfers, but exclude budget loans. Other sources of financing is defined as the difference between expenditures and all revenues and transfers.

Source: Authors' calculations based on data from the Ministry of Finance.

Table 15
Determinants of Per Capita Expenditures on Public Health and Physical Education¹, 1994-1997

	Intercept	Regional Collections	FFSR Transfers	Other Transfers ²	Other Sources of Finance ²	Cost of Living Index	Pct. Pop. Younger Work Age	Pct. Pop. Older Work Age	Pct. Pop. in Poverty	R ²
1994	181.46	0.10	0.08	0.14	-0.13	-0.08	-3.61	-2.68	-0.14	0.97
1995	119.41	0.11	0.18	0.06	-0.01	0.54	-2.34	-2.10	-0.26	0.95
1996	534.25	0.09	0.16	-0.05	0.16	0.37	-9.97	-9.37	-0.79	0.94
1997	534.49	0.06	-0.16	-0.24	0.07	2.24	-6.34	-13.84	-3.10	0.90

¹ Bold indicates statistical significance at the 5 percent level.

² Other transfers include mutual settlements, subventions and other minor transfers, but exclude budget loans. Other sources of financing is defined as the difference between expenditures and all revenues and transfers.

Source: Authors' calculations based on data from the Ministry of Finance.

Table 16
Expenditure Assignment in the Budget Code, 1998

A. Expenditures Financed Exclusively from the Federal Budget	B. Jointly Financed Expenditures (Federal, Regional and/or Local)	C. Expenditures Financed Exclusively from Budgets of Subjects of the Russian Federation	D. Expenditures Financed Exclusively from Local Budgets
<p>C support of the activity of the President of the Russian Federation, Federal Assembly of the Russian Federation, Accounting Chamber of the Russian Federation, Central Election Commission of the Russian Federation, federal executive authorities and their regional branches, other expenditures on general government administration in accordance with the list established in the process of approval of the federal law on the federal budget for the next fiscal year</p> <p>C functioning of the federal judiciary system</p> <p>C international activities in the interests of the Federation: financial support of the implementation of inter-state agreements and agreements with international financial institutions; international cultural, scientific and information cooperation of federal executive authorities; quotas of the Russian Federation in international organizations; other expenditures in the area of international cooperation determined in the course of approval of the federal law on the federal budget for the next fiscal year</p> <p>C expenditures on national defense and national security, conversion of defense industries</p> <p>C fundamental research and promotion of scientific and technological progress</p> <p>C state support of railway, air and sea transport</p> <p>C state support of nuclear power generation</p> <p>C liquidation of consequences of emergencies and natural disasters of federal significance</p> <p>C space research and use</p> <p>C maintenance of federally-owned institutions or institutions managed by public authorities of the Russian Federation</p> <p>C formation of federal property</p> <p>C servicing and repayment of sovereign debt of the Russian Federation</p> <p>C compensation of expenditures incurred by state extrabudgetary funds in relation to state pensions, allowances and other social benefits to be financed from the federal budget pursuant to the legislation of the Russian Federation</p> <p>C replenishment of state reserves of precious metals and gems, and state material reserves</p> <p>C elections and referendums in the Russian Federation</p> <p>C federal investment program</p> <p>C implementation of decisions taken by federal public authorities, which increased budgetary expenditures or reduced budgetary revenues of budgets of other levels</p> <p>C execution of individual public responsibilities delegated to other levels of power</p> <p>C financial support of subjects of the Russian Federation</p> <p>C official statistics</p> <p>C miscellaneous</p>	<p>C state support of industries (save for nuclear power generation), construction and construction industry, agriculture, road and river transport, communications, roads and metro systems</p> <p>C law enforcement activities</p> <p>C fire safety activities</p> <p>C research, design and surveys in support of scientific and technological progress</p> <p>C social protection of the population</p> <p>C environmental protection, protection and reproduction of natural resources, hydrometeorological activities</p> <p>C prevention and liquidation of consequences of emergency situations and natural disasters of inter-regional significance</p> <p>C development of the market infrastructure</p> <p>C development of federal and inter-ethnic relations</p> <p>C operation of Election Commissions of subjects of the Russian Federation pursuant to the legislation of the Russian Federation</p> <p>C support of mass media</p> <p>C financial assistance to other budgets</p> <p>C other expenditures to be jointly financed by the Russian Federation, subjects of the Russian Federation and municipalities</p>	<p>C operation of legislative (representative) and executive authorities of subjects of the Russian Federation</p> <p>C servicing and repayment of the sovereign debt of subjects of the Russian Federation</p> <p>C elections and referenda in subjects of the Russian Federation</p> <p>C implementation of regional targeted programs</p> <p>C formation of state property of subjects of the Russian Federation</p> <p>C international and foreign economic relations of subjects of the Russian Federation</p> <p>C maintenance and development of enterprises, institutions subordinate to public authorities of subjects of the Russian Federation</p> <p>C activities of mass media in subjects of the Russian Federation</p> <p>C financial assistance to local budgets</p> <p>C execution of individual public responsibilities delegated to the municipal level</p> <p>C compensation of additional expenditures resulting from decisions taken by public authorities of subjects of the Russian Federation, which increased budgetary expenditures or reduced budgetary revenues of local budgets</p> <p>C other expenditures associated with the execution of responsibilities of subjects of the Russian Federation</p>	<p>C operation of local self-government authorities</p> <p>C formation and management of municipal property</p> <p>C organization, maintenance and development of education, health care, social and physical culture institutions and sports facilities, mass media and other institutions owned by municipalities or managed by local self-government authorities</p> <p>C operation of municipal law enforcement agencies</p> <p>C organization, maintenance and development of municipal housing and utilities</p> <p>C municipal road construction and maintenance</p> <p>C amelioration of municipally-owned areas and plantation of trees</p> <p>C organization of domestic waste utilization and recycling (save for radioactive waste)</p> <p>C maintenance of burial places managed by municipalities</p> <p>C organization of transport service for the population and institutions owned by municipalities or managed by local self-government authorities</p> <p>C fire safety</p> <p>C environmental protection in municipalities</p> <p>C implementation of targeted programs adopted by local self-government authorities</p> <p>C servicing and repayment of municipal debt</p> <p>C targeted subsidization of households</p> <p>C maintenance of municipal archives</p> <p>C municipal elections and local referendums</p> <p>C implementation of other decisions taken by local self-government authorities and other expenditures classified as local issues to be determined by representative bodies of local self-government in accordance with budget classification of the Russian Federation</p>

Table 17
Legislated Sharing Rates of Major Taxes in the Russian Federation
(Percent of Total)

	Law on Basic Principles of Taxation, 1991		1992, Q1		1992, Q2-Q4		1993		1994 Q1		1994 Q2-Q4		1995		1996		1997		1998	
	Fed	Reg	Fed	Reg	Fed	Reg	Fed	Reg	Fed	Reg	Fed	Reg	Fed	Reg	Fed	Reg	Fed	Reg	Fed	Reg
VAT ^a	100	0	ad hoc negot.		80	20	80-50	20-50	75	25	75	25	75	25	75	25	75	25	75	25
Profit tax	0	100 ^b	47	53	41	59	31	69	37-34 ^c	63-66 ^c	37-34 ^c	63-66 ^c	34	66	34	66	34	66	34	66
Personal income tax	0	100 ^b	0	100	0	100	0	100	0	100	0	100	10	90	10	90	0	100	40	60
Excise on alcohol	50	50	50	50	50	50	50	50	50	50	50	50	50	50	50	50	50	50	50	50
Energy excises	---	---	100	0	100	0	100	0	100	0	100	0	100	0	100	0	100	0	100	0
Excises on domestic productions	---	---	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	0	100	0	100	0	100	0	100	0	100	0	100

SOURCE: Modified and updated from *Fiscal Management in Russia*, World Bank, 1996

^a VAT on imports, precious metals and stones in assigned 100 percent at the federal level.

^b These taxes could be shared with the federal government.

^c The federal profit tax rate is 13 percent; regional profit tax rates range up to 22 (for most enterprises) and 25 (for banks and insurance companies) percent of profits. The sharing percentages in the table are calculated based on the 13/22 and 13/25 profit tax rate.

Table 18
Status of Taxes in the Tax Code* (1998)

Federal Taxes		Regional Taxes		Local Taxes	
C	Value Added Tax	C	Tax on Property of	C	Land Tax
C	Excises on Specific Goods		Organizations	C	Individual Property Tax
C	Excises on Raw Materials	C	Tax on Real Estate	C	Tax on Advertising
C	Enterprise Profits Tax	C	Road Tax	C	Inheritance or Gift Tax
C	Capital Gains Tax	C	Transport Tax	C	Local License Fees
C	Personal Income Tax	C	Sales Tax		
C	Contributions to State Off-	C	Tax on Gambling Enterprises		
	Budget Funds	C	Regional License Fees		
C	Customs Duties				
C	State Duties				
C	Tax on Subsoil Use				
C	Tax on Rehabilitation of				
	Minerals Raw Materials Base				
C	Tax on Additional Income				
	from Hydrocarbons				
	Production				
C	Fee for the Right of Use of				
	Fauna and Water Biological				
	Resources				
C	Forest Tax				
C	Water Tax				
C	Ecological Tax				
C	Federal License Fees				

* The assignments are in the General Part of the Tax Code which has been approved by the Duma and signed by the President. The specific part of the Tax code which develops each of the taxes has not been approved as of June 1999.

Table 19
Own Revenues and Shared Revenues as a Percentage of
Consolidated Subnational Collections (Excluding Transfers and Subventions)

	1992	1993	1994	1995	1996	1997
Own Source Revenues	16.7	16.5	27.0	29.3	38.7	40.5
Shared Revenues	83.3	84.5	73.0	70.7	61.3	59.5

Source: Ministry of Finance and Igudin (1998).

Table 20
Distribution of Revenues Between the Levels of Government, 1992-1997

	1992	1993	1994	1995	1996	1997
Total Tax Revenues	100.0	100.0	100.0	100.0	100.0	100.0
Federal Budget	60.3	45.6	48.3	48.4	49.8	42.5
Consolidated Subnational Budget	39.7	54.4	51.7	51.6	50.2	57.5
Regional Budgets	19.4	28.3	26.4	26.2	23.7	--
Local Budgets	20.3	26.1	25.3	25.4	26.5	--
Profit Tax	100.0	100.0	100.0	100.0	100.0	100.0
Federal Budget	41.3	32.5	35.1	35.6	36.6	32.4
Consolidated Subnational Budget	58.7	67.5	64.9	64.4	63.4	67.6
Regional Budgets	30.1	39.7	38.9	39.0	38.4	--
Local Budgets	28.6	27.7	26.1	25.4	25.0	--
VAT	100.0	100.0	100.0	100.0	100.0	100.0
Federal Budget	75.1	64.4	67.2	75.4	74.8	68.5
Consolidated Subnational Budget	24.9	35.6	32.8	24.6	25.2	31.5
Regional Budgets	15.1	22.5	21.1	14.0	15.7	--
Local Budgets	9.8	13.1	11.7	10.6	9.5	--
Personal Income Tax	100.0	100.0	100.0	100.0	100.0	100.0
Federal Budget	0	0	0.6	9.0	9.2	2.3
Consolidated Subnational Budget	100.0	100.0	99.4	91.0	90.8	97.7
Regional Budgets	22.8	23.2	25.8	24.2	24.6	--
Local Budgets	77.2	76.8	73.6	66.8	66.3	--
Excise Taxes	100.0	100.0	100.0	100.0	100.0	100.0
Federal Budget	47.9	50.5	60.1	72.8	86.8	80.2
Consolidated Subnational Budget	52.1	49.5	39.9	27.2	13.2	19.8
Regional Budgets	41.9	40.2	32.0	21.3	10.3	--
Local Budgets	10.2	9.3	7.9	5.8	2.9	--
Property Taxes	100.0	100.0	100.0	100.0	100.0	100.0
Federal Budget	0	0	0	5.0	0.8	1.2
Consolidated Subnational Budget	100.0	100.0	100.0	95.0	99.2	98.8
Regional Budgets	52.4	45.5	41.8	42.3	44.1	--
Local Budgets	47.6	54.5	58.2	52.8	55.1	--

Table 20 (Continued)
Distribution of Revenues Between the Levels of Government, 1992-1997

	1992	1993	1994	1995	1996	1997
Natural Resources Tax	100.0	100.0	100.0	100.0	100.0	100.0
Federal Budget	0	29.1	15.3	24.4	25.1	19.7
Consolidated Subnational Budget	100.0	70.9	84.7	75.6	74.9	80.3
Regional Budgets	63.9	40.6	44.9	36.4	39.0	--
Local Budgets	36.1	30.3	39.7	39.2	35.9	--
Other Taxes	100.0	100.0	100.0	100.0	100.0	100.0
Federal Budget	91.8	77.8	70.7	61.3	43.1	42.9
Consolidated Subnational Budget	8.2	22.2	29.3	38.7	56.9	57.1
Regional Budgets	2.3	8.9	13.1	17.3	16.6	--
Local Budgets	5.9	13.3	16.2	21.4	40.2	--
Non-Tax Revenues	100.0	100.0	100.0	100.0	100.0	100.0
Federal Budget	59.2	--	38.0	70.9	75.1	66.4
Consolidated Subnational Budget	40.8	--	62.0	29.1	24.9	33.6
Regional Budgets	33.6	--	35.7	22.2	18.8	--
Local Budgets	7.1	--	26.3	7.0	6.1	--
Intergovernmental Transfers	100.0	100.0	100.0	100.0	100.0	100.0
Federal Budget	6.6	--	3.5	1.7	0.3	0.2
Consolidated Subnational Budget	93.4	--	96.5	98.3	99.7	99.7
Regional Budgets	33.1	--	54.4	42.6	46.4	--
Local Budgets	60.3	--	42.1	55.7	53.2	--

Source: Freinkman et al. (1998) and Ministry of Finance.

Table 21
Russia: Consolidated Subnational Own Source Revenue Collections, 1997

	Rb. Trillion	Percent of Total
<i>Property Taxes</i>	46.9	39.0
Individual Property Tax	0.4	0.4
Enterprise Property Tax	46.4	38.6
Other Property Taxes	0.1	0.1
<i>Natural Resource Collections</i>	28.6	23.8
Mineral Resource Payments	11.9	9.9
Tax on Depletion of Mineral Resources	6.9	5.7
Land tax	8.4	7.0
Other Natural Resource Collections	1.4	1.2
<i>Other Taxes</i>	44.8	37.2
Tax on Housing and Militia Maintenance	23.6	19.6
Wage Fund Tax	9.1	7.6
Other Income Taxes	0.4	0.3
Special Sales Tax	0.9	0.7
Other Sales Taxes	6.6	5.5
Other Taxes	4.1	3.4
Subnational Own Source Tax Revenues	120.3	100.0
<i>Memo: Regional Non-tax Revenues</i>	21.0	17.5
<i>Memo: Shared Revenue Collections</i>	208.7	173.4

Source: Authors' calculations based on data from the Ministry of Finance.

Table 22
Summary of Legislative Control over Subnational Own Source Revenues

Tax	Legislative Level Determining Tax Base	Legislative Level Determining Tax Rate	Budget(s) To Which Tax Revenues Go
Tax on Enterprise Property	Fed	Reg (Fed limit)	Fed / Reg
Tax on Property of Physical Persons	Fed	Fed ¹	Loc
Land Tax	Fed	Fed ²	Fed / Reg / Loc
Tax on Use of Mineral Resources	Fed	Fed	Fed / Reg / Loc
Tax on Depletion of Mineral Resources	Fed	Fed	Fed / Reg
Transport Tax (incl. Road Users, Vehicle Owners and Acquisition tax)	Fed/Reg	Fed / Reg	Reg
Housing and Militia Maintenance Taxes	Fed	Loc (Fed limit)	Loc
Educational Charges	Fed	Reg (Fed limit)	Reg / Loc
Advertising Tax	Fed	Loc (Fed limit)	Loc
Resort Fees	Loc	Loc	Loc
Exchange Transaction Fees	Fed	Fed	Fed / Reg
Tax on Resale of Automobiles and Computers	Fed	Loc (Fed limit)	Loc
Racing and Gambling Charges	Loc	Loc	Loc
Tax on Industrial Construction in National Resort Areas	Loc	Loc	Loc

¹ Regional and local governments can lower the rate and add exemptions.

² Regional governments set concrete minimum rate for particular kind of land and local governments can raise the rate.

Table 23
 Distribution of Revenues Between the Levels of the Government, 1992-1997
 (as percent of GDP)

	1992	1993	1994	1995	1996	1997
Federal Budget	18.8	13.1	13.6	14.2	12.8	12.4
Consolidated Region Budget	13.8	16.6	18.2	14.8	14.9	15.7
Regional Budgets	6.8	8.4	9.7	7.5	7.2	--
Local Budgets	7.0	8.2	8.5	7.3	7.7	--
Total	32.6	29.7	31.8	29.0	27.7	28.1

Note: Transfers to other levels of government may result in double counting; amounts may not add up due to rounding.

Source: Freinkman et al. (1998) and Ministry of Finance.

Table 24
Evaluation of Composition of Revenues for Subnational Governments in Real Terms, 1992-1997

	In Real Terms: Per Capita 1995 Rubles						In Real Terms: Index (1994=100)					
	1992	1993	1994	1995	1996	1997	1992	1993	1994	1995	1996	1997
Own and Shared Revenues	1,692.9	1,805.9	1,345.5	1,277.5	1,182.5	1,296.9	125.8	134.2	100.0	94.9	87.9	96.4
<i>o/w EPT</i>	684.3	849.1	576.0	511.4	297.5	270.3	118.8	147.4	100.0	88.8	51.7	46.9
<i>o/w PIT</i>	320.4	329.6	318.6	224.8	239.5	290.2	100.6	103.5	100.0	70.6	75.2	91.1
<i>o/w VAT</i>	369.7	302.0	194.0	164.5	193.9	210.1	190.6	155.7	100.0	84.8	100.0	108.3
<i>o/w Exc</i>	82.4	66.0	54.8	44.6	38.3	49.5	150.4	120.4	100.0	81.4	69.9	90.3
Other & Non Tax Revenues	32.3	19.0	237.1	113.1	102.4	141.6	13.6	8.0	100.0	47.7	43.2	59.7
Transfers (Excl. Loans)	106.0	340.2	468.0	191.8	211.0	193.6	22.7	72.7	100.0	41.0	45.1	41.4
Total Revenues	1,831.2	2,165.1	2,050.6	1,583.9	1,497.1	1,632.9	89.3	105.6	100.0	77.2	73.0	79.6

Source: Authors' calculations based on data from the Ministry of Finance.

Table 25
Russia: Measures of Vertical Fiscal Imbalance for the Subnational Sector, 1997

Coefficient of Vertical Fiscal Imbalance # 1	0.293
Coefficient of Vertical Fiscal Imbalance # 2	0.843
Coefficient of Vertical Fiscal Imbalance # 3	0.918

Source: Authors' calculations based on data supplied by the Ministry of Finance

Note: Coefficients of vertical fiscal imbalance were calculated, following Hunter (1977):

$$\text{Coefficient \#1} = 1 - \left(\frac{\text{Revenue Sharing \% Untied (Equalizing) and Other Transfers}}{\text{Total Expenditures}} \right)$$

$$\text{Coefficient \#2} = 1 - \left(\frac{\text{Untied (Equalizing) and Other Transfers}}{\text{Total Expenditures}} \right)$$

$$\text{Coefficient \#3} = 1 - \left(\frac{\text{Other Transfers}}{\text{Total Expenditures}} \right)$$

Table 26
Measures of Vertical Fiscal Imbalance for the Subnational Sector:
An International Comparison

Country	Coefficient #1	Coefficient #2
Russia ¹	0.293	0.843
Austria ²	0.186	0.717
Belgium	0.156	0.512
Denmark	0.172	0.611
Estonia ³	0.088	0.686
Finland ⁴	0.191	0.654
Germany ²	0.244	0.794
Latvia ³	0.069	0.491
Lithuania ³	0.111	0.869
Netherlands	0.288	0.345

Sources: Calculated from data supply by the Ministries of Finance of the Russian Federation, Estonia, Latvia and Lithuania; Revenue Statistics of OECD Member Countries 1965-1992; IMF Government Finance Statistics Yearbook 1994.

Note: See Table 25 for definitions of the coefficients. Unless otherwise mentioned, 1991 data used.

¹ Based on 1997 fiscal data.

² Subnational sector includes Länder as well as local governments.

³ Based of 1994 fiscal data.

⁴ Coefficients calculated using 1990 local expenditure data.

Table 27
 Measures of Regional Fiscal Disparities in the Russian Federation:
 Per Capita Revenue Collections (including Federal Share), 1993-1997
 (in thousands of Rubles)

	Mean	Coefficient of Variation	Minimum	Maximum
1993	251.8	0.68	31.2	943.5
1994	722.0	0.85	24.4	3,878.0
1995	1,950.9	1.12	158.7	15,681.4
1996	2,732.0	1.33	268.9	24,862.2
1997	3,553.9	1.61	477.0	43,881.9

Source: Authors' calculations based on data from the Ministry of Finance.

Table 28
 Concentration of Total Revenue Collections (Including Federal Share) Among Regions:
 Share of Total Revenues Collected by Selected Regions, 1993-1997

	1993	1994	1995	1996	1997
Five highest collection regions	33.7	32.0	34.5	37.6	40.9
Ten highest collection regions	47.5	45.8	48.0	50.9	54.9
Twenty highest collection regions	64.9	64.6	67.2	68.9	70.9
Coef. of Variation, Per Capita Revenue Collections	0.68	0.85	1.12	1.33	1.61

Source: Authors' calculations based on data from the Ministry of Finance.

Table 29
 Concentration of Regional Revenue Collections Among Regions:
 Share of Regional Revenues Collected by Selected Regions, 1992-1997

	1992	1993	1994	1995	1996	1997
Five highest collection regions	27.0	28.0	30.2	30.4	31.6	34.1
Ten highest collection regions	42.2	43.1	44.1	45.2	46.5	49.4
Twenty highest collection regions	62.7	62.7	64.1	64.5	65.6	67.3
Coef. of Variation, Per Capita Revenue Collections	0.89	0.67	0.86	0.86	1.14	1.51

Source: Authors' calculations based on data from the Ministry of Finance.

Table 30
Analysis of Regional Natural Resource Tax (NRT) Collections, 1994-1997

	Average, NRT as Percent of Regional Collections	Coefficient of Variation, Per Capita NRT Collections	Correlation Per Capita NRT Collections with:	
			Per Capita GRP ¹	Per Capita Regional Collections
1994	2.60	3.03	0.81	0.80
1995	5.23	2.35	0.88	0.85
1996	6.55	2.85	0.95	0.94
1997	7.68	3.40	0.95	0.96

¹ Data on 1996 GRP was used for 1997.

Source: Authors' calculations based on data from the Ministry of Finance.

Table 31
Fund for Financial Support of the Regions (FFSR)

First Window: Regions in Need of Financial Assistance

(Variables are from base year adjusted for legislation changes since then)

Step 1:

$$\text{Claim by Region } i = \left(\left[\frac{\text{Average revenue per capita in the group of regions}}{\text{Average expenditure per capita in the group of regions}} \right] (0.92) \& \left[\frac{\text{Per capita revenues in Region } i}{\text{Average revenue per capita in the group of regions}} \right] \right) \times \text{Population of Region } i$$

$$\text{where } \left[\frac{\text{Average expenditure per capita in the group of regions}}{\text{Average revenue per capita in the group of regions}} \right] (0.92)$$

Step 2: (For those regions with a positive claim in Step 1)

$$\text{Share of Region } i \text{ in the pool of funds for Window I } S_{ii} = \frac{\text{Claim by Region } i}{\text{Total claims from all regions}} \times 100$$

Step 3:

$$\text{Actual equalization grant to region } i \text{ under Window I } S_{ii} \times \text{Pool of funds available for Window I}$$

Table 31 (Continued)
Fund for Financial Support of the Regions (FFSR)

Second Window: Regions in Need of Additional Financial Assistance

(Variables are from base year adjusted for legislation changes since then)

Step 1:

$$\text{Claim by Region } j = \left(\frac{\text{Current expenditures in Region } j}{\text{Revenues in Region } j} \right) \times \left[\left(\frac{\text{Revenues in Region } j}{\text{Revenues in Region } j} \right) \% \left(\frac{\text{Equalization grant for Region } j \text{ in Window I}}{\text{Revenues in Region } j} \right) \right]$$

Step 2: (For those regions with a positive claim in Step 1)

$$\text{Shared Region } j \text{ in the pool of funds for Window II} = S_{1j} \times \frac{\text{Claim by Region } j}{\text{Total claims from all regions}}$$

Step 3:

$$\text{Actual equalization grant to Region } j \text{ under Window II} = S_{1j} \times \left(\frac{\text{Pool of funds available for Window II}}{\text{Total claims from all regions}} \right)$$

Table 32
Formula for Allocating FFSR Transfers, 1999

Step 1: Determine the amount of funding for the FFSR

Step 2: Determine *Per Capita Revenue* (a measure of fiscal capacity):

$$R_i^{PC} = \frac{R_i}{N_i}.$$

Step 3: Determine *Index of Budget Expenditures* (a measure of expenditure need):

$$K_i = \sum_{j=1}^s H_{ij} / \min_i \sum_{j=1}^s H_{ij}.$$

Step 4: Determine *Normalized Per Capita Revenue*:

$$RP_i = \frac{R_i^{PC}}{K_i}.$$

Step 5: Assign equalization transfers (t_i) for regions for which $RP < \overline{RP}$:

$$t_i = (\overline{RP} - RP_i) @ N_i @ K_i.$$

Step 6: If necessary, only equalize to threshold RP_v :

$$RP_v = \frac{\sum_{i=1}^m RP_i @ N_i @ K_i}{\sum_{i=1}^m @ N_i @ K_i}.$$

NOTE: In Step 2, R_i is adjusted revenue collections (a measure of fiscal capacity) and N_i is population; in Step 3, H_{ij} is the per capita expenditure norm for region i and expenditure category j . When the amount of transfers assigned in Step 5 exceeds the size of the FFSR, the equalization threshold is lowered to RP_v , which is determined in an iterative process that simultaneously determines the number of regions eligible for equalization funds(m).

Table 33
 Funding Sources for the Regions of the Russian Federation:
 Average Regional Funding by Source as Percent of Total Expenditures, 1992-1997

	Own, Shared and Other Regional Revenues	FFSR Transfers ¹	Other Transfers and Settlements	Other Sources of Financing ²
1992	87.2	--	16.3	-3.5
1993	75.7	--	30.1	-5.8
1994	66.5	9.4	26.4	-2.3
1995	73.6	17.3	5.6	3.6
1996	68.5	15.0	7.6	9.0
1997	67.9	15.6	4.2	11.5

¹ The FFSR was introduced in 1994; in earlier years equalization was achieved through variable sharing rates and other equalizing transfers.

² Determined as expenditures minus revenues and transfers; consists mainly of budget loans and borrowing.

Source: Authors' calculations based on data from the Ministry of Finance.

Table 34
Federal Transfers to the Regions, 1992-1997
(percent of GDP)

	1992	1993	1994	1995	1996	1997
Total Fed. Transfers and Loans	1.76	2.71	4.21	1.86	2.37	2.67
Total Federal Transfers	1.66	2.66	4.15	1.79	2.11	1.92
“Subventions”	0.79	0.69	0.14	0.06	0.09	0.13
FFSR	0.00	0.00	0.79	1.19	1.07	1.27
Mutual Settlements	0.87	1.95	2.27	0.42	0.83	0.43
Other Transfers	0.00	0.02	0.95	0.12	0.12	0.09
Budget Credits and Loans	0.10	0.05	0.07	0.06	0.26	0.75

Source: Ministry of Finance.

Table 35
Evaluation of Composition of Transfers for Subnational Governments in Real Terms, 1992-1997

	In Real Terms: Per Capita 1995 Rubles						In Real Terms: Index (1994=100)					
	1992	1993	1994	1995	1996	1997	1992	1993	1994	1995	1996	1997
Transfers (excl. Budget Loans)	106.0	340.2	468.0	191.8	211.0	193.6	22.7	72.7	100.0	41.0	45.1	41.4
o/w FFSR	--	--	95.6	128.0	109.1	131.5	--	--	100.0	133.9	114.1	137.5
o/w Mutual Settlements	--	255.7	307.2	47.1	85.2	44.6	--	83.3	100.0	15.3	27.7	14.5
Total Revenues (excl. Loans and borrowing)	1,831.2	2,165.1	2,050.6	1,583.9	1,497.1	1,632.9	89.3	105.6	100.0	77.2	73.0	79.6

Source: Ministry of Finance.

Table 36
Regression Analysis: Per Capita FFSR Transfers¹, 1994-1997

	Intercept	Per Capita GRP	Cost of Living Index	Pct. Pop. Younger Work Age	Pct. Pop. Older Work Age	Pct. Pop. in Poverty	Tax Effort ²	R ²
1994	-1,743.0	-13.0	6.8	26.3	37.3	-1.4	-8.6	0.68
1995	-4,219.4	-18.6	16.6	72.0	69.8	-4.5	-1.0	0.81
1996	-3,450.8	-7.6	13.1	65.3	50.7	0.3	-2.3	0.76
1997	-5,000.5	-10.3	18.9	93.8	72.1	-1.8	-3.0	0.74

¹ Bold indicates statistical significance at the 5 percent level.

² Tax effort is defined as total collections as a percent of gross regional product (GRP).

Source: Authors' calculations based on data from the Ministry of Finance.

Table 37
 Regression Analysis: Per Capita Other Transfers (Excluding Budget Loans) ¹, 1994-1997

	Intercept	Per Capita GRP	Cost of Living Index	Pct. Pop. Younger Work Age	Pct. Pop. Older Work Age	Pct. Pop. in Poverty	Tax Effort ²	R ²
1994	-2,569.6	-55.2	12.3	37.3	29.1	-1.1	14.6	0.79
1995	-1,509.4	-6.7	6.5	16.3	24.2	0.9	4.9	0.63
1996	-1,306.9	-0.6	6.1	15.0	24.5	-1.3	3.0	0.59
1997	-1,498.2	-6.1	0.8	-29.4	-35.4	-0.8	1.5	0.36

¹ Bold indicates statistical significance at the 5 percent level.

² Tax effort is defined as total collections as a percent of gross regional product (GRP).

Source: Authors' calculations based on data from the Ministry of Finance.

Table 38
Regression Analysis: Allocation of (Per Capita) Regional Resources¹, 1994

	Intercept	Per Capita GRP	Cost of Living Index	Pct. Pop. Younger Work Age	Pct. Pop. Older Work Age	Pct. Pop. in Poverty	Tax Effort ²	R ²
Total Collections	-932.9	182.2	-0.4	11.4	-4.7	0.3	44.2	0.98
Regional Rev.	-1,746.2	138.8	2.4	30.4	15.1	-0.7	29.3	0.89
After FFSR	-3,489.2	125.8	9.2	56.7	52.4	-2.1	20.7	0.94
After All Transfers	-6,058.9	70.6	21.6	94.0	81.5	-3.1	35.3	0.90
Reg. Expenditures	-6,147.0	60.4	22.7	91.0	84.9	-3.2	35.3	0.89

¹ Bold indicates statistical significance at the 5 percent level.

² Tax effort is defined as total collections as a percent of gross regional product (GRP).

Source: Authors' calculations based on data from the Ministry of Finance.

Table 39
Regression Analysis: Allocation of (Per Capita) Regional Resources¹, 1995

	Intercept	Per Capita GRP	Cost of Living Index	Pct. Pop. Younger Work Age	Pct. Pop. Older Work Age	Pct. Pop. in Poverty	Tax Effort ²	R ²
Total Collections	-4,352.6	268.1	-1.6	51.6	39.2	8.5	88.8	0.98
Regional Rev.	120.5	100.6	5.55	16.9	-21.9	-5.6	32.2	0.91
After FFSR	-4099.0	82.0	22.1	55.1	47.9	-10.1	31.1	0.91
After All Transfers	-5,608.3	72.3	28.7	71.4	72.1	-9.3	36.0	0.90
Reg. Expenditures	-6,690.1	61.1	33.2	82.2	68.0	-7.9	66.5	0.88

¹ Bold indicates statistical significance at the 5 percent level.

² Tax effort is defined as total collections as a percent of gross regional product (GRP).

Source: Authors' calculations based on data from the Ministry of Finance.

Table 40
Regression Analysis: Allocation of (Per Capita) Regional Resources¹, 1996

	Intercept	Per Capita GRP	Cost of Living Index	Pct. Pop. Younger Work Age	Pct. Pop. Older Work Age	Pct. Pop. in Poverty	Tax Effort ²	R ²
Total Collections	-4,305.9	254.3	-4.4	44.1	38.9	4.6	113.3	0.96
Regional Rev.	-878.6	127.5	8.3	-4.4	-2.2	-5.9	24.1	0.92
After FFSR	-4329.4	119.9	21.4	61.0	48.4	-5.67	21.8	0.88
After All Transfers	-5,636.3	119.3	27.5	76.0	72.9	-6.9	24.8	0.89
Reg. Expenditures	-13,435	115.7	48.8	202.8	203.6	-11.7	48.1	0.92

¹ Bold indicates statistical significance at the 5 percent level.

² Tax effort is defined as total collections as a percent of gross regional product (GRP).

Source: Authors' calculations based on data from the Ministry of Finance.

Table 41
Regression Analysis: Allocation of (Per Capita) Regional Resources ¹, 1997

	Intercept	Per Capita GRP	Cost of Living Index	Pct. Pop. Younger Work Age	Pct. Pop. Older Work Age	Pct. Pop. in Poverty	Tax Effort ²	R ²
Total Collections	-9,363.2	348.0	-4.9	106.5	135.4	17.0	115.2	0.97
Regional Rev.	-4,187.1	210.6	3.57	63.0	51.7	-1.0	27.5	0.96
After FFSR	-9,192.0	200.3	22.4	156.8	123.8	-2.8	30.2	0.93
After All Transfers	-7,693.9	194.2	23.2	127.4	88.3	-3.6	31.7	0.94
Reg. Expenditures	-16,465	200.2	48.2	264.8	240.8	-4.22	43.7	0.94

¹ Bold indicates statistical significance at the 5 percent level.

² Tax effort is defined as total collections as a percent of gross regional product (GRP).

Source: Authors' calculations based on data from the Ministry of Finance.

Table 42
Explaining Tax Effort for Regional Collections ¹, 1994-1997

	Intercept	Per Capita GRP	Cost of Living Index	Business Taxes ²	Personal Income Tax ²	Sales Taxes ²	FFSR Transfer (pct. Exp)	R ²
1994	6.40	-0.46	0.06	0.08	-0.12	0.14	-0.14	0.48
1995	8.35	-0.06	0.03	0.06	-0.12	0.07	-0.04	0.45
1996	11.36	-0.02	0.02	0.06	-0.09	0.01	-0.05	0.34
1997	6.65	0.05	0.02	0.07	0.00	0.12	-0.03	0.41

¹ Bold indicates statistical significance at the 5 percent level.

² Expressed as percent of total regional revenues.

Source: Authors' calculations based on data from the Ministry of Finance.

Table 43
Explaining Tax Effort for Overall Collections (Including Federal Share)¹, 1994-1997

	Intercept	Per Capita GRP	Regional Share of Collect.	Cost of Living Index	Business Taxes ²	Personal Income Tax ²	Sales Taxes ²	FFSR Transfer (% Exp)	R ²
1994	28.5	-0.64	-0.25	0.08	0.09	-0.17	0.17	-0.21	0.57
1995	38.3	-0.06	-0.31	0.04	-0.01	-0.10	0.04	-0.10	0.73
1996	47.0	-0.02	-0.40	0.02	-0.01	-0.10	-0.07	-0.09	0.66
1997	36.4	0.09	-0.42	0.03	0.09	0.01	0.23	-0.02	0.51

¹ Bold indicates statistical significance at the 5 percent level.

² Expressed as percent of total regional revenues.

Source: Authors' calculations based on data from the Ministry of Finance.

Table 44
Percent of the Executed Share of a Region in the FFSR

	1995	1996	1997		1995	1996	1997
Karelia Republic	50.0	103.7	115.0	Belgorod Oblast	80.9	136.4	80.0
Komi Republic	87.6	157.2	111.0	Voronezh Oblast	101.2	104.1	113.0
Arhangelsk Oblast	103.0	136.2	74.0	Kursk Oblast	94.6	105.5	96.0
Nenetski AO	94.3	90.7	142.0	Lipetsk Oblast	Donor	Donor	Donor
Vologda Oblast	90.3	122.8	13.0	Tambov Oblast	126.8	82.3	110.0
Murmansk Oblast	90.0	25.8 ^a	67.0	Kalmykia Oblast	98.0	98.2	120.0
Saint Petersburg	Donor	79.2	94.0	Tatarstan Oblast	0.0	Donor	121.0
Leningrad Oblast	104.5	73.6	114.0	Astrakhan Oblast	106.0	106.1	106.0
Novgorod Oblast	107.7	98.3	105.0	Volgograd Oblast	83.5	151.2	83.0
Pskov Oblast	96.3	113.8	94.0	Penza Oblast	95.4	126.6	106.0
Bryansk Oblast	97.9	134.1	84.0	Samara Oblast	Donor	Donor	Donor
Vladimir Oblast	92.0	104.6	114.0	Saratov Oblast	95.0	88.8	104.0
Ivanovo Oblast	101.7	82.7	113.0	Ulyanovsk Oblast	94.7	117.9	89.0
Kaluga Oblast	94.2	120.5	96.0	Adygeya Republic	96.1	115.3	178.0
Kostroma Oblast	93.1	132.0	87.0	Dagestan Republic	133.5	87.8	111.0
Moscow	Donor	Donor	Donor	Ingushetiya Republic	101.0	107.6	216.0
Moscow Oblast	74.1	50.1 ^b	69.0	Kabardino-Balkariya Rep.	99.0	105.7	138.0
Orlov Oblast	102.1	91.6	149.0	Karachayevo-Cherkessia Rep.	94.9	90.0	132.0
Ryasan Oblast	70.1	121.1	80.0	North Ossetia Republic	95.2	112.2	99.0
Smolensk Oblast	92.9	101.6	119.0	Chechnya Republic	207.9	89.2	17.0
Tver Oblast	93.9	109.1	112.0	Krasnodar Krai	93.8	89.2	116.0
Tula Oblast	97.8	116.8	114.0	Stavropol Krai	109.8	114.0	100.0
Yaroslavi Oblast	Donor	25.1	111.0	Rostov Oblast	107.3	88.6	116.0
Marii El Oblast	102.2	105.0	109.0	Bashkortostan Republic	Donor	Donor	Donor
Mordoviya Oblast	101.6	98.9	121.0	Udmurtia Republic	108.0	102.7	38.0
Chuvashia Oblast	107.0	101.6	122.0	Kurgan Oblast	91.6	105.5	110.0
Kirov Oblast	92.2	96.8	113.0	Orenburg Oblast	97.1	118.4	102.0
Nizhny Novgorod Oblast	Donor	114.2	94.0	Perm Oblast	81.0	26.4 ^c	66.0

^aInstead of 0.0 percent, received 25.8 from its 1995 share. ^bInstead of 0.0 percent, received 50.1 from its 1995 share. ^cInstead of 0.0 percent, received 26.4 from its 1995 share.

Table 44 (Continued)
Percent of the Executed Share of a Region in the FFSR

	1995	1996	1997		1995	1996	1997
Komi-Permyatski AO	101.4	89.1	102.0	Irkutsk Oblast	86.2	105.1	73.0
Sverdlosk Oblast	Donor	Donor	Donor	Ust-Ordynsk Buryat AO	93.3	1.9 ^d	111.0
Chelabinsk Oblast	72.4	121.4	81.0	Chita Oblast	97.7	87.7	103.0
Gorny Altay Republic	111.0	137.6	172.0	Aginskiy Buryat AO	100.4	102.5	110.0
Altay Krai	105.9	98.1	112.0	Sakha Republic (Yakutia)	89.8	56.2	68.0
Kemerovo Oblast	95.3	136.6	83.0	Everyskaya AO	156.2	100.7	105.0
Novosibirsk Oblast	103.1	11240.0	141.0	Chukotka AO	111.7	84.1	128.0
Omsk Oblast	94.4	214.3	74.0	Primorsky Krai	90.3	19.0 ^e	68.0
Tomsk Oblast	98.1	112.8	104.0	Khabarovsk Krai	93.2	123.9	101.0
Tyumen Oblast	89.6	46.7	107.0	Amur Oblast	100.5	77.8	116.0
Khanty-Mansiyiski AO	Donor	Donor	Donor	Kamchatka Oblast	94.5	39.5 ^f	74.0
Yamalo-Nenetski AO	Donor	Donor	Donor	Koryaksky AO	103.3	147.4	95.0
Buryatia Republic	101.5	77.4	143.0	Magadan Oblast	101.0	100.6	108.0
Tuva Republic	105.6	118.4	178.0	Sakhalin Republic	98.9	93.3	106.0
Khakissiya Republic	99.4	91.8	100.0	Kaliningrad Oblast	94.9	73.3	123.0
Krasnoyarsk Krai	Donor	Donor	Donor				
Taymyr AO	98.1	103.3	124.0				
Evenkiyski AO	94.7	129.0	153.0				

^dInstead of 0.0 percent, received 1.9 percent from its share in 1995. ^eInstead of 0.0 percent, received 19.0 percent from its share in 1995. ^fInstead of 0.0 percent, received 39.5 percent from its share in 1995.

Table 45
Russia: Consolidated Budget Execution as Percent of GDP, 1992-1997

Federal Government	1992	1993	1994	1995	1996	1997
Revenues	18.80	13.13	13.60	14.24	12.82	12.41
Expenditures	39.65	23.77	23.40	18.45	19.80	15.73
Balance, after transfers	-20.85	-10.65	-9.80	-4.21	-6.98	-3.32
Balance, before transfers	-19.44	-8.08	-6.20	-2.10	-4.64	-0.71
Consol. Regional Government	1992	1993	1994	1995	1996	1997
Revenues	13.78	16.59	18.23	14.83	14.91	15.72
Expenditures	12.34	16.06	18.24	15.15	15.58	16.96
Balance, after transfers	1.45	0.53	-0.01	-0.32	-0.67	-1.24
Balance, before transfers	0.04	-2.04	-3.62	-2.43	-3.01	-3.85
GDP, Rb. trillion	19.0	171.5	610.7	1630.1	2200.0	2602.3

Source: Freinkman et al.(1998) and Ministry of Finance.

Table 46
Relative Size of Subnational Debt: Comparison of Selected Countries

	Subnational Debt as Percent of Subnat. Expenditures	Subnational Debt as Percent of GDP
Australia (1996)	57	11
Germany (1996p)	91	21
Switzerland (1995)	100	25
United States (1995)	65	13
Russia (Estimate 1997)	40	6

Sources: Freinkman et al. (1998) and computed by authors based on data from the IMF.

Table 47
Regression Analysis: Per Capita “Other Sources of Financing”^{1,2}, 1994-1997

	Intercept	Per Capita GRP	Cost of Living Index	Pct. Pop. Younger Work Age	Pct. Pop. Older Work Age	Pct. Pop. in Poverty	Tax Effort ³	R ²
1994	-88.2	-10.1	1.1	-2.9	3.4	-0.1	-0.1	0.20
1995	-1081.8	-14.2	4.6	10.7	-4.1	1.4	30.5	0.35
1996	-7798.3	-3.5	21.3	12.7	13.1	-4.8	23.3	0.62
1997	-8541.6	7.7	24.8	136.0	151.4	0.7	0.6	0.60

¹ Defined as expenditures minus revenues and transfers; “other sources of financing” mostly consists of budget loans and borrowing.

² Bold indicates statistical significance at the 5 percent level.

³ Tax effort is defined as total collections as a percent of gross regional product (GRP).

Source: Authors’ calculations based on data from the Ministry of Finance.