Preliminary Draft
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Fiscal Federalist Relations in Russia: A Case for Subnational Autonomy

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November 2000

* The ideas contained in this paper are those of the authors, and do not necessarily coincide with official positions of the Russian government or the Organisation for Economic Co-operation and Development.

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I) Introduction

A number of studies have identified the state of fiscal federalist relations as a major obstacle to successful economic transition in the Russian Federation.[1] The current system offers weak incentives to regional and local levels of government for responsible budgetary management and the adoption of policies conducive to entrepreneurship, fair competition, and the development of new private firms. This finds reflection in a poor climate for business and investment in Russia compared to a number of other transition economies, including excessive entry barriers, licenses, fees, taxes, and various types of extortion.[2] A major improvement of the climate for entrepreneurship and investment in Russia requires changes in the conditions under which regional and local Russian officials operate. Such is the motivation for a fundamental reform in fiscal federalist relations outlined in the new Economic Programme of the Russian government (Programma…(2000)).

As Russia stands poised to embark on these reforms, a number of recent studies in economics and political economy have raised questions about previously accepted wisdom and practices in the area of fiscal federalism. Many of the relatively new ideas concern precisely developing or transition countries that are still in the process of building market institutions, while at the same time struggling to achieve lasting stabilisation and growth. An important strand in this literature proposes that a properly designed decentralisation in fiscal federalist relations can effectively serve as an engine for market reform and growth (Weingast (1995), Monitola, Qian, and Weingast, (1995)). On the other hand, a number of other studies warn of the dangers of decentralisation, again often focusing precisely on problems in developing or transition economies (Fukasaku and de Mello Jr. (1998), Prud'homme (1995)). The relative advantages and disadvantages of decentralisation also underlie current policy debates within Russia. Is the cure for poor economic policies and behaviour of regional and local administrations a crackdown by the central government or a more effective and rational decentralisation? Recent Russian reform documents and initiatives contain an often confusing mix of proposals for greater subnational autonomy and measures aimed at increasing central control. Indeed, the appropriate reform in Russia would most likely involve a certain combination of the two. But how should they be optimally combined?

This paper considers the question posed above through an examination of the current state of fiscal federalist relations in Russia and an evaluation of basic reform options in light of the relevant literature. We conclude that the Russian system of interbudgetary relations indeed stands to profit greatly from an explicit decentralisation in decision-making authority. But the particular characteristics of the Russia economy suggest accompanying this decentralisation with a package of additional measures to ensure overall financial control, the achievement of basic social policy goals, and the proper alignment of incentives for state organs. This entails a dual approach that simultaneously creates genuine autonomy and responsibility at lower levels of government, while centralising to the federal level a greater share of resources, particularly in the short and medium term. A longer-term strategy should gradually increase in the share of resources in subnational budgets, as institutions for subnational finance and responsibility become stronger, more durable macroeconomic stability is achieved, and social distress among the population subsides. The strategy outlined in this paper is consistent with, and builds on,

[1] See, for example, OECD (2000b), Shleifer and Treisman (2000).

[2] See, for example, Radaev (1996), OECD (1997b), Frye and Shleifer (1997), Johnson, McMillan and Woodruff (2000).

recommendations in OECD (2000b) and the general directions set out in the Economic Programme of the Russian government (Programma…2000).

The following section briefly describes the state of fiscal federalist relations in Russia, drawing upon both OECD (2000b) and more recent information. The next section turns to the general question of decentralisation for the case of Russia. Final sections outline a comprehensive direction of reform and discuss current strategies and Programmes of the Russian government.

II) The State of Fiscal Federalist Relations in Russia

The ministerial product-line hierarchy of the Soviet system left little room for any sort of regional or local autonomy. In effect, all state revenue was first centralised and then allocated according to the national plan. Subnational administrations began to play an increasing role in resource allocation with the weakening of the product-line ministries in the 1980s. This process intensified during the transition to a market economy in the 1990s, leading to a significant devolution of effective power and authority to the regional (Subject of the Federation) level of government. By and large, this devolution of power did not follow a specific plan or central legislation, instead deriving from strong autonomous centrifugal forces that followed a weakening of the central government and its corresponding inability to meet a large part of former expenditure obligations. In a rather chaotic environment, regions lobbied for greater shares and control of revenue through bilateral agreements with the centre, while the federal government continually pushed expenditure responsibilities downward.

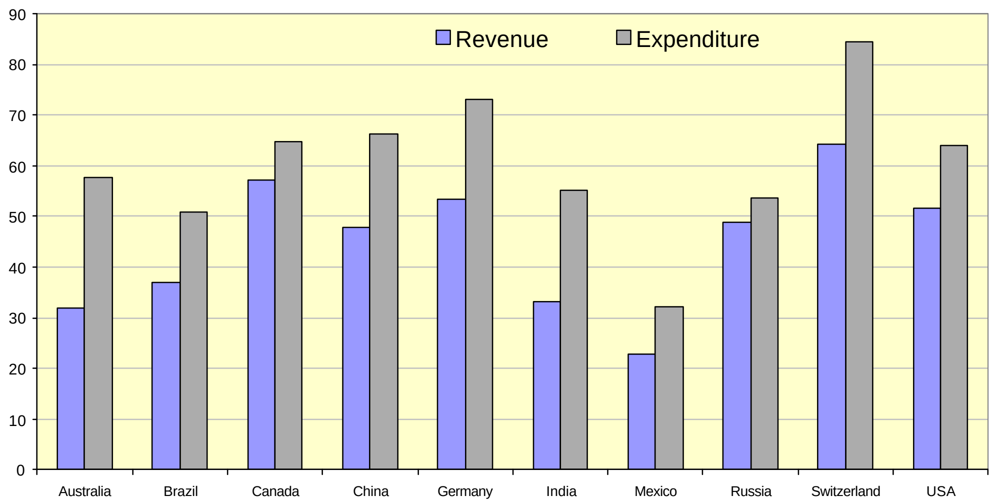
Official legislation evolved along with this process, but generally opposed this chaotic decentralisation process through measures aimed at bringing regional and local finance under greater central control. One important accomplishment since the mid-1990s has been the creation of somewhat more uniform rules for revenue sharing and expenditure assignments for all Subjects of the Federation. These rules have, to a large degree, replaced the separate bilateral agreements of the past.[3] But legislation and actual practice in Russian fiscal federalist relations still remain rather far apart in many areas. Therefore, an understanding and assessment of the state of fiscal federalism in Russia requires a distinction between the system as it exists on paper, according to various laws and regulations, and how it actually works in practice. A much more detailed treatment of a number of the issues in this section can be found in OECD (2000b). In theory, the current system of fiscal federalist relations is distinguished by an extremely high degree of central control over subnational budgets. In practice, subnational administrations have ample means to circumvent this control. The nature of this game accounts for important distortions in the incentives of state officials at regional and local levels.

The Russian fiscal federalist system now consists of three main levels: federal, 89 (regional) Subjects of the Federation), including 9 autonomous *okrugs* that are considered part of larger subjects, and several thousand local administrations. In various contexts, however, the system may need to be viewed as something between a 2 and 4-5 tier hierarchy. On the one hand, there is federal legislation that refers to "consolidated (regional and local) budgets of Subjects of the Federation" as one legal entity. On the other hand, actual administrative structure varies from region to region, with some Subjects of the Federation

[3] Tatarstan and Bashkortostan (as well as Sakha Yakutiia until the mid-90s) are exceptional cases where special bilateral agreements have been important in recent years, although the conditions of these agreements have also come to resemble more closely the (uniform) conditions imposed for other regions. A current political initiative of the central government is to discontinue such special agreements and, at least formally, subject these republics to the same uniform conditions as other Subjects of the Federation . But this process is unlikely to be quick or easy. As in the past, the draft federal budget for 2001 prescribes special treatment for these republics in allowing them to keep a share of revenue from federal taxes on their territories for financing federal expenditures.

interacting directly with a series of local (third-tier) municipalities and other regions where only larger cities and districts have municipality status, along with a possible subdivision into smaller subordinate administrations. A mixture of these two models is also possible.[4] A typical Russian region will have one or two strong cities or districts that supply the vast majority of tax revenue, while most of the remaining districts, usually without any sort of real tax base, are financed primarily by the regional budget.[5]

Figure 1: The Share of Subnational budgets in Consolidated State Revenue (before transfers) and Expenditures in Selected Countries



Note: revenue is total revenue before transfers, including tax sharing. Expenditures include transfers
Data for Russia are from 1999, for Australia and Germany 1998, for China, Switzerland, and the United States for 1997, India 1996, Canada 1995, and Brazil 1994.
Source: OECD, IMF

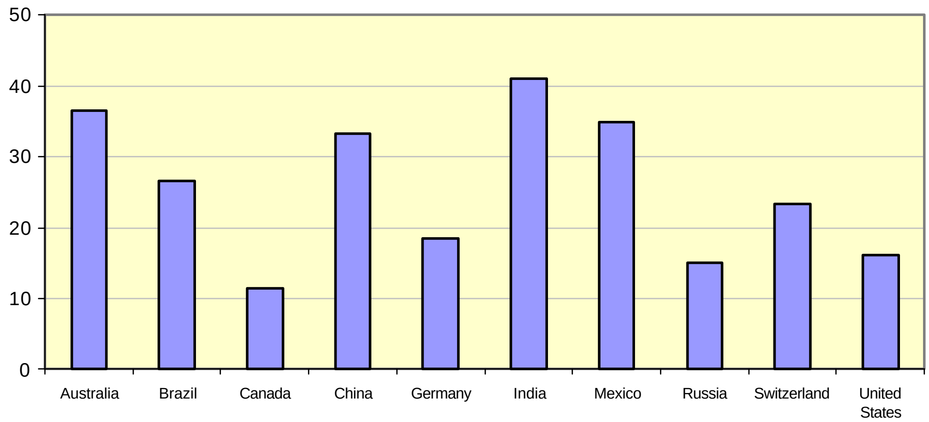
The two most commonly employed measures of fiscal decentralisation in applied economic studies are the share of subnational budgets in consolidated revenue and expenditures and the degree to which subnational budgets consist of revenue raised on their territories as opposed to transfers. By both of these (aggregate) measures, the Russian system appears rather decentralised (Figures 1 and 2), at least at the regional (Subject of the Federation) level. In the 1990s, the share of consolidated subnational revenue (before transfers) in all state revenue gradually increased from 40 to 56 per cent in 1998, before falling back to 49 per cent in 1999. This share has decreased somewhat again in 2000, due in large part to higher federal revenues from export taxes and some recent changes in tax legislation, but remains well above 40 per cent. As shown in Figure 1, this places Russia close to China and a number of developed federations, such as Germany and the United States, and above Brazil, India, and Mexico. The comparative share of subnational expenditures is lower, reflecting a relatively low average share of transfers in subnational revenue (Figure 2). The share of federal transfers in aggregate subnational (consolidated regional) revenue stood at roughly 15 per cent in 1999. This can be contrasted with India, China, and Mexico, where transfers account for over 30 per cent of subnational revenue, as well as Brazil where they account for over 25 per cent. But a rather high degree of variance does exist across different Subjects of the Federation according to this measure. While transfers account for less than 10 per cent of the revenues of many Subjects of the Federation, this measure reaches 50-60 per cent for over 20 of the least developed regions.

[4] In fact, current legislation allows any populated area within a municipality to declare itself a separate independent municipality.

[5] See Box 5 in OECD (2000b) for more details.

The variance in local transfers is even greater, with a number of rural municipalities receiving transfers accounting for over 80 per cent of revenue.

Figure 2: The Share of Transfers in Consolidated Regional State Revenues in Selected Countries



Note: country data are from the same years as figure 1
Source: OECD, IMF

Measures of decentralisation according to (formal) subnational autonomy tell another story altogether. Here, the legacy of the over-centralised Soviet system survives, further bolstered by a number of measures in the second half of the 1990s that place even further limitations on the autonomy of subnational administrations. The vast majority of subnational revenue and expenditure obligations are determined by laws and regulations determined of a higher level of government, most notably the federal level. A single federal tax body (ministry) collects all taxes, transferring the majority of this revenue to the federal treasury, where it is then allocated to various budgets. The federal government sets the rates and sharing rules of the major taxes as a part of the annual federal budget law. Only roughly 15 per cent of regional and local (explicit) revenue derives from taxes over which the relevant administrations have any sort of real decision-making authority, and even these taxes are usually rigidly regulated from above or subject of federal ceilings. The new Tax Code of 1999 (Part I) and 2000 (Part II) reinforced the narrow limits on subnational autonomy, restricting subnational taxes and their methodology to a short possible list. The government further plans to replace the former federal ceiling on the regional profit tax rate of 19 per cent to a fixed rate of the same amount. From 1 January 2000, regions lost their ability to offer tax exemptions to their (shared) part of federal taxes, including the profit tax.

Table 1: The Composition of Regional and Local Budgetary Revenue.

In per cent

	1997		1998		1999		2000 (Jan-Jun)	
	Regional	Local	Regional	Local	Regional	Local	Regional	Local
Total revenues *of which:*	100	100	100	100	100	100	100	100
tax collection	69	67	64	64	75	71	76	68
Shared taxes	55	54	50	52	60	56	58	53
Regulated[1]	31	40	30	38	25	42	23	39
of which: profit tax	--	11	--	10	-	17	-	15
Fixed federal[2]	3	12	3	12	4	12	4	13
Subject to federal ceiling[3]	21	2	17	2	31	2	31	1
of which: profit tax	19	--	15	--	20	-	25	-
Other taxes[4]	13	8	14	12	15	15	18	15
Non-tax revenue	6	2	6	4	6	4	6	4
Transfers from higher-level budgets and extra-budgetary funds	24	31	30	32	19	25	18	28

1. Rates and sharing rules are set annually by the superior level of government.
a) For regional budgets: VAT, personal income tax, excises, and tax for natural resources (except payments for natural deposits and land tax).
b) For local budgets: VAT, personal income tax, profit tax, single imputed income taxes, and taxes for natural resources (except payments for natural deposits and land tax).

2. Rates are set entirely by the superior level of government and sharing rules fixed by federal legislation.
a) For regional budgets - payments for natural deposits.
b) For local budgets - payments for natural deposits, sales tax, and property tax (enterprises).

3. Rates and sharing rules are set primarily by the superior level of government, but allowing some discretion to change tax rates (bases) within fixed federal ceilings (norms) and/or to introduce additional tax exceptions.
a) For regional budgets - profit tax, single imputed income tax (legal entities), and road tax.
b) For local budgets - land tax.

4. Rates, tax bases and exemptions are set decentrally, but within a federal legal framework.
a) For regional budgets - sales tax, property tax (enterprises), licences and registration fees, and single imputed income tax (personal).
b) For local budgets - licenses and registration fees, property tax (persons), advertising tax, social infrastructure and other local taxes (are to be cancelled after the introduction of the sales tax).

Source: OECD calculations based on data and information of the Ministry of Finance.

This places subnational tax autonomy for Russia considerably lower than in most other federations, especially in developed federations such as Canada, Switzerland, and the United States, where subnational governments have almost complete autonomy in choosing tax bases, types, and rates.[6] By this measure, the Russian system is also far more centralised than that of China, India, and Brazil.[7] Among other

[6] See OECD (1997a) and OECD (1999b).

[7] In India, where shared taxes account for about 60 per cent of subnational government tax revenue the states nevertheless possess legislative authority over the remaining taxes assigned exclusively to the states (Baipaj and

federations, only Germany and Mexico have exceedingly low explicit subnational tax autonomy that is comparable to Russia. Not only are Germany and Mexico not as large and diverse as Russia, but a number of specialists have identified over-centralisation as source of inefficiency and poor incentives in subnational state organs in both of these countries.[8]

The determination of expenditures for subnational administrations resembles somewhat the revenue side of their budgets. Formal responsibilities assigned to regions and localities include (regional) state administration, finance of regional organisations, housing subsidies, transportation, and roads of purely regional significance. In addition, regions share a certain ambiguous "joint responsibility" with the federal government for large expenditure categories such as education, health, social policy, and economic subsidies. Current Russian legislation assigns expenditure responsibilities to lower budgets without any guarantees of autonomy in the determination and execution of these expenditures. In this context, most expenditure categories in subnational budgets are subject to rigid federal regulations relating to the obligatory size and exact breakdown of budgetary outlays. In addition, regional and local budgets have been extraordinarily burdened by the accumulation of numerous unfunded federal expenditure mandates throughout the 1990s. The majority of these mandates dictate subsidies or exemptions in housing, communal services, transportation, etc. for various groups of the population. Although these mandates have the a legal status as only "recommended" rather than obligatory since 1993, technical legal ambiguities have made at least a good number of them obligatory for all practical purposes, and recognised as such by the courts.[9] Only recently has the Russian government tried to take inventory of the stock of existing mandates and their burden on subnational budgets. A survey of 68 of 89 Subjects of the Federation in 1999 asked for an identification of current outstanding federal mandates. Although regions typically did not identify those mandates that they did not recognise as binding, the combined burden of the 25 most important federal mandates (identified by at least 10 per cent of all regions) was as much as 60 per cent of all consolidated regional expenditure. The combined burden of all mandates that were recognised by at least one region in the survey amounted to 170 per cent of all consolidated regional expenditure[10]. Thus, fundamental problems in ambiguous and irrational expenditure assignments, stressed by Christine Wallich (Wallich (1994)) in the first comprehensive study of fiscal federalism in Russia, remain unsolved, and may have actually become more serious in the second half of the 1990s.

As indicated above, while transfers account for only 15 per cent of subnational revenues on average, they are of critical importance for a large number of regions and localities. Russian transfer policies have suffered in the past from both a lack of transparency and a "soft" adjustment to current budgetary needs, thereby weakening incentives and responsibility at lower levels of government. This is particularly true for

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Sachs, (1999)).[7] In China, subnational governments also acquired significant autonomy after the reforms of the late 1970s and early 1980s. The system of contracting between provincial governments and the central authorities, introduced in 1980, effectively allowed provincial governments to retain all marginal revenues. Provinces also had effective control over taxes and fees for extrabudgetary funds, which were not subject to sharing with the central government (Monitola, Qian, and Weingast (1995)). Brazilian states are unusual in that they control one of the country's most important taxes (a regional VAT), accounting for almost two-thirds of the total income of Brazilian states. The senate sets limits for the rate of this tax, but within these limits the states are allowed to alter the rate and can also change the tax base with the approval of a body representing all the states (Ter-Minassian (1997), Dillinger and Web (1999)).

8 For Germany, see Sphan and Feottinger (1997), Wurzel (1999), and Rehm (1998). For Mexico, see Carenga and Weingast (2000), Carrera-Hernandez (1999), and OECD (2000a).

9 The courts have increasingly impounded the funds of local authorities pending the fulfilment of obligations according to federal mandates. An important legal ambiguity has concerned wording in the federal budget law to the effect that mandates are accounted for in the determination of transfers to the regions. This would exclude them from non-funded status. As indicated above, gross federal transfers amount for less than 15 per cent of subnational expenditures. Even if it were true the majority of these transfers were intended to assist subnational administrations with the fulfilment of such obligations, they would not come close to accounting for all of these mandates.

10 OECD (2000b), pp. 131.

transfers from regional to local levels of government (Zhuravskaia (1998)). Consequently, transfer policies have been a primary target for reform since the mid-1990s. The methodology and allocation of federal transfers has been improved notably in recent years. This includes the concentration of the vast majority of federal transfers into a single Fund for the Financial Support of Subjects of the Federation (FFSSF). Under a 3-year government Programmeme for the reform of interbudgetary relations for 1999-2001, the methodology for determining the size and the allocation of this fund has become more transparent and rigid, depending less on recent budgetary performance in a given region. The new methodology has also concentrated federal transfers more effectively in the poorest regions. But other types of less transparent federal transfers still exist outside of the FFSSF, including various loans, debt restructuring, and so-called "mutual settlements." At the regional level, a law of 1997 on local self-government sought to make the rules determining transfers from regions to localities more rigid over time. For various reasons, however, this law appears to have been largely ineffective in practice (OECD (2000b)). In 2000, the Ministry of Finance has issued a methodological recommendation to the regions for more effective transfer policies, borrowing from the federal experience. But this is still only in the form of a recommendation.

A virtual explosion in subnational debt issues followed a federal law of 1993 that granted regional and local administrations the right to issue debts under rather few restrictions. The existence of numerous and sometimes complicated subnational debt instruments complicates an assessment of the outstanding debt and creditworthiness of different administrations. These instruments include various bills of exchange, sometimes issued by "authorised" banks or other affiliates, direct loans, and subnational loan guarantees. While official statistics place outstanding subnational debt at a rather insignificant level (less than 2 per cent of GDP), this methodology fails to account for numerous categories of debt. On the basis of partial survey information from 53 Subjects of the Federation, OECD (2000b) estimated the combined burden of subnational debt and loan guarantees (46 per cent in arrears) to be roughly 8per cent of GDP, more than quadruple the official figure. Over 35 per cent of this debt was estimated to have been in arrears in 1999, indicating regional defaults and insolvency on a massive scale in wake of the 1998 crisis. More recent estimates of the Ministry of Finance show a similar picture, with almost 40 per cent of outstanding debts of subnational governments in arrears as of April 2000.[11]

The main difference between the Russian fiscal federalist system as it exists on paper and practice is the fact that subnational administrations do exercise a high degree of autonomy in their jurisdictions, particularly at the level of the Subject of the Federation.[12] The actual system is significantly decentralised with respect to autonomy as well as resources. Given the highly centralised nature of the formal system, however, this autonomy is realised primarily in an informal manner. As argued below, this fundamental contradiction between formal centralisation and informal autonomy is the source of many of the distortions and incentive problems that plague interbudgetary relations in Russia today.

Subnational organs have a number of means for gaining influence and leverage over economic organisations and financial institutions operating on their territories.[13] This includes direct participation in the capital, "indirect" participation through affiliated companies, control of utilities, control of various inspections empowered to administer penalties and fines, close ties with the courts and federal anti-trust or tax bodies, licensing, and the police. Surveys of Russian businesses continue to emphasise good relations

[11] Data of the Ministry of Finance of the Russian Federation.

[12] The source for much of remaining discussion in this section is OECD missions to 10 representative regions (Subjects of the Federation) during 1998, 1999, and 2000. On these missions, OECD teams were received by regional and local administrations, branches of federal organs and the Central Bank, and representatives of the business and financial community. The focus of these missions was subnational finance and problems in fiscal federalism.

[13] OECD (2000) provided a more detailed analysis of some of the primary informal tools available to regional and local officials, with a stress on the period of 1997-99. The discussion here echoes OECD (2000), although accounts for changes in 2000.

with regional and local administrations as a prerequisite for success. Federal organs operating in the regions typically have close relations with the regional administration, depending on the latter for a number of reasons, sometimes even for the provision of office space. Federal organs in the regions are typically staffed by local officials with a background in the regional administration. Until recently, the regional governor had informal veto power over the selection of some federal representatives, most notably the head of the branch of the tax ministry. Only in the context of recent administrative reforms, including new rules for the Council of the Federation (upper house of parliament) and the creation of 7 new administrative macro-districts in the federal hierarchy, has the influence of regional governors over federal structures perhaps begun to decline.

In this context, regional administrations almost always make direct use of enterprises and financial institutions on their territories for the provision of public goods and services. First, most large industrial enterprises inherited social infrastructures such as housing, schools, hospitals, etc. Many of these firms, particularly those that are profitable, continue to finance this infrastructure, even in the event that ownership has been formally transferred to the municipality More fundamentally, it is quite typical for profitable enterprises to be burdened with the provision of subsidies to the region in many various forms, such as entire networks of retail consumer goods outlets (operated at a loss), housing, road work, monuments, sports stadiums, and the like. In return, these firms can receive various special privileges or protection from the administration, including explicit or implicit tax exemptions, debt restructuring, and protection from bankruptcy or competition. Complicated bilateral agreements of this sort between administrations and large "budget-generating (biudzetoobrazuiushchie)" enterprises are the general rule. Administrations themselves, or their affiliates, are often significant shareholders in these firms as well, and the activation of (tax) debt restructuring, debt/equity swaps and bankruptcies during 1998-2000 appears to have increased the extent of this shareholding. External management of financially distressed firms is often at least implicitly under the control of administrations. A primary advantage for administrations in relying on such bilateral bargaining and the direct provision of public goods is the avoidance of the ubiquitous tax sharing and rigid central regulations on expenditures in the formal system. The region effectively becomes a 100 per cent marginal claimant on (implicit) taxes and exercises complete control over the allocation of "expenditures." Lower profits due to the provision of regional public services offer the enterprise an advantage as well, lowering its tax obligations to the federal government. Many regions also have one or more "authorised" commercial banks that hold can various funds of the administration, offer deficit finance, and issue bills of exchange for use in fiscal policy. Analytically, it is quite difficult to distinguish the actual "budgets" of administrations from those of their affiliated firms and financial institutions.

Various extra-budgetary funds represent another informal tool of fiscal policy for subnational administrations. While these funds are technically illegal, numerous loopholes exist. For example, such funds can be set up as independent non-profit organisations with a murky shareholding structure that disguises administration ownership. "Volunteer" contributions can then be solicited from economic organisations. Small businesses have complained in particular of extortion by state organs through pressure to make donations to such funds.[14] These funds again offer the dual advantage of avoiding revenue sharing and maintaining full control over expenditures. In addition to such informal funds are subnational branches of the explicit national extra-budgetary funds. Regions have typically exercised greater degree of control over some of these funds than the explicit budget, although recent measures are due to bring explicit extra-budgetary funds under federal control and shift their administration to the Federal Tax Ministry.[15] Subnational administrations also possess their own special accounts (*Sumy po porucheniiu*), which contain various fines, other off-budget payments, and some "excess" budgetary funds

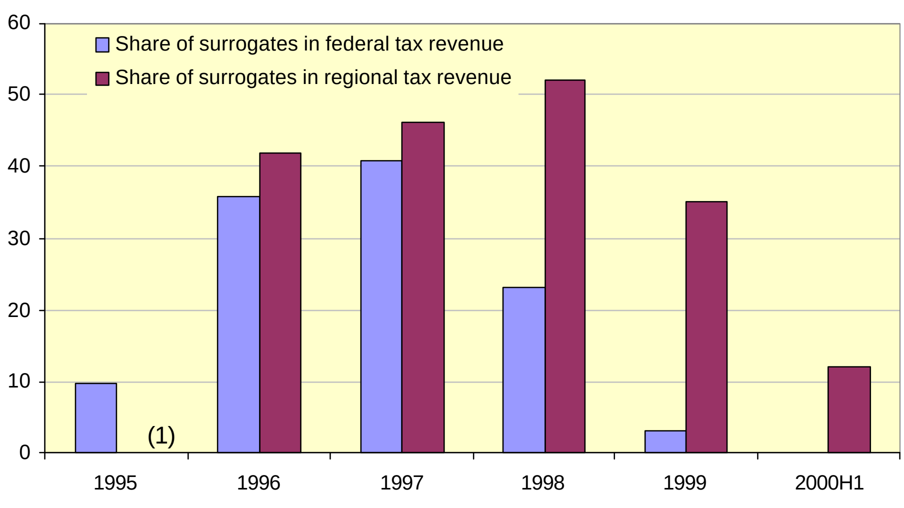
[14] See, for example, Radaev (1996)

[15] . A higher degree of subnational control over some of these funds relative to the explicit budget in the past was linked in OECD (2000b) to a real shift in resources toward these funds in recent years.

from economising on certain expenditure categories. These accounts hold something close to the equivalent of 5 per cent of resources in the explicit budget on average, and for some regions much more. They share the advantages of extra-budgetary funds and the direct provision of public goods through economic organisations stressed above.

The OECD Economic Survey of 2000 (OECD (2000)) also placed particular emphasis on money surrogates, particularly debt offsets, as primary tools for the conduct of relatively independent fiscal policies at the subnational level. This includes direct control over resource allocations (through the arrangement of barter chains), various means of keeping a greater part of shared revenue in the region, an inherent lack of transparency in accounting that allows for "creative book-keeping," the difficulty of monitoring such arrangements by federal bodies, and the freedom for individualised tax treatment in the spirit of the bilateral relations described above. This continues to be the case, despite the fact that several factors have supported a significant decline in the share of surrogates in reported subnational tax revenue in 2000. In late 1999 and early 2000, the Ministry of Finance signed (and extended) agreements with the majority of regional administrations that linked their eligibility for federal transfers to a number of conditions, including a substantial reduction of the share of surrogates in tax revenue. In addition, subnational administrations were outright forbidden to collect their shares of federal taxes in surrogates in 2000, while the federal treasury has moved from a firm-by-firm to an aggregate rule for the division of tax revenue between budgets as of 1 January 2000. Now, in contrast to the past, if a subnational administration collects taxes from one firm in money surrogates, it potentially stands to lose cash revenue collected from other firms. A greater amount of cash in the regional economy and higher enterprise profitability after the depreciation of the rouble and strengthening of export prices has also facilitated a greater use of cash in budgetary operations. Figure 3 illustrates the changes in the share of reported money surrogates in subnational tax revenue from 1995 to the first half of 2000. The average fell all the way to 12 per cent in the first half of 2000, although it remains over 30 per cent in a number of regions.

Figure 3: The Share of Money Surrogates in Consolidated Regional Tax Revenue: 1995-2000



(1) data are not available for 1995
Source: OECD, Ministry of Finance.

While the reliance of subnational administrations on money surrogates has certainly dropped in 2000, OECD missions to Russian regions in 2000 have led us to suspect that the official figures reported in Figure 3 significantly exaggerate the extent of this decline. As the agreements between the Ministry of Finance and Subjects of the Federation concern only the reports of the tax ministry, regions now employ schemes that allow them to reduce the share of reported surrogates while continuing to make wider use of them in practice. For example, the most common use of surrogates in budgetary operations since 1996 have been debt offset operations. Under such an operation, firm A, owing taxes to a regional or local administration, makes a delivery of a good or service to firm B in satisfaction of this tax debt, firm B then makes a delivery of equal value to firm C, and so on, until a final delivery is make to a budgetary recipient, allowing the administration to write off budgetary expenditures. Under this operation, the federal tax ministry receives documentation from the regional administration on the value of this offset and reports revenue in money surrogates. More recently, a common scheme has been to set up the same offset operation but involve a commercial bank, typically an "authorised" bank that works for the administration. The commercial bank makes a short term (often one-day) loan to firm A for the regional share of a tax payment owed. When firm A pays its taxes, the administration receives this share and returns it to the bank. Firm A then makes the usual delivery to firm B as "repayment" of the loan and the same barter chain is repeated. But now the tax ministry receives and reports payment in cash.[16] As in the past, the administration remains in control of variables such as prices at which goods and services are being valued, allowing it the flexibility to offer individualised tax treatment to firms as part of the bilateral bargaining discussed above. The administration also remains in direct control of resource allocation and may possibly make money itself at the expense of budgetary recipients.[17]

The typical unfeasibility of fulfilling all federal norms and mandates for budgetary expenditures offers another important fiscal policy tool for subnational administrations: the selective sequestration of expenditure categories. For example, the 25 most important mandates identified by regions in the survey of 1999 were reportedly fulfilled on average by only 31 per cent.[18] The choice itself of what extent to fulfil each category of expenditure obligations grants an obvious degree of discretion to subnational authorities. While the aggregate consolidated regional budget deficit on a cash basis was close to 1.0 per cent of GDP between 1996-98, OECD (2000b) roughly estimates that the corresponding deficit on a accruals basis, which accounts for the underfulfilment of 25 most important mandates, would be at least 5.5 per cent.

In conclusion to this section, despite some recent measures aimed at increasing federal control, subnational administrations in the Russian Federation continue to possess ample means and strong incentives for conducting their own implicit independent fiscal policies. A crackdown by the federal government appears to have shifted some of the emphasis away from money surrogates and toward other sources, perhaps most

[16] It should be noted that there is one major possible disadvantage to regional administrations of this new scheme relative to a direct (classical) offset operation. In the latter case, subnational administrations can still "collect" their regional and local taxes from firms that are not paying their federal taxes. For the new scheme to work, firm A must pay its federal taxes in cash at the same time that it pays subnational taxes in kind. This is the case because the tax ministry and federal treasury receives this money and automatically divides it according to the sharing rule. Indeed, if it were not for this disadvantage, reported non-cash tax collection would probably be even lower in 2000. This disadvantage disappears for purely regional or local taxes.

[17] The primary reason why the administration generally profit relative to the budgetary recipients in this case is that the value of goods and services are almost always evaluated at significantly higher than cash value. In fact, a scheme recently found in one Russian region was as follows: cash revenue of the administration is transferred to a securities broker firm that works for the administration. This broker buys so-called "commodity bills of *exchange (tovarnye vekseliia*)" of a firm A, perhaps directly from the firm or perhaps on the secondary market. Such bills of exchange can be presented to firm A for a delivery of goods or services of equivalent (face) value. The same sort of barter chain is set up, with a budgetary recipient receiving the last delivery. The interesting additional point here is that the broker buys these illiquid commodity bills of exchange at a significant discount. But the budgetary expenditure at the end of the chain is written off at face value, leaving "profits" for the broker and/or administration.

[18] The courts did impound the accounts of a number of local administrations for this reason, however.

notably the direct provision of public goods and services through enterprises. The recent wave of tax debt restructuring, debt/equity swaps, and bankruptcies appears to have solidified the leverage of administrations over enterprises in many cases. Thus, the Russian fiscal federalist system continues to feature a high degree of informal subnational autonomy, which stands in contrast to the highly centralised formal system.

III) What Type of Reform is Needed?

The fundamental contradiction between the highly centralised formal system and substantial (informal) subnational autonomy is a major source of problems in Russian fiscal federalist relations. First, the highly centralised and often unfeasible nature of the formal system prevents the effective delegation of financial responsibility to lower levels of government. This not only concerns the establishment of appropriate disciplinary measures from above, but also political pressure from voters. Subnational officials can effectively pass the blame for fiscal problems to the federal government. Regular federal bailouts of subnational wage arrears in recent years bear witness to this problem (OECD(2000b)), as do the continuation of transfer policies that bypass the FFSSF. Second, the inherently underground nature of subnational policies itself encourages rent-seeking as opposed to reform and growth-oriented policies from at least two points of view. By their very nature, these policies lack transparency and are not monitored by the usual federal organs, including the Anti-Monopoly Ministry and Fiscal Control Inspection. Second, the bilateral bargaining process between administrations and firms that form the basis of informal fiscal policies naturally favours the development of long-term ties between state officials and incumbent firms, as opposed to policies aimed at fair competition and the impersonal support of new private businesses that experience rapid turnover. Still more problems resulting from the combination of high formal central control and informal autonomy are discussed below.

The resolution of this contradiction would theoretically require some combination of recognised formal autonomy and measures aimed at reducing "informal" behaviour. But the strategy of the Russian government in the second half of the 1990s focused on the reduction of both formal and informal subnational autonomy. On balance, in fact, these measures appear to have increased the severity of the contradiction. This includes the decision to revoke the rights of subnational governments to set their own taxes in 1996, the restriction of subnational taxes in the Tax Code to a small fixed list subject to heavy federal regulation, an increasing burden of federal expenditure mandates, crackdowns on the use of surrogates in budgetary operations, the elevation of the status of federal authorities in the region (such as granting ministerial status to the Anti-Monopoly body and "service" status to the federal insolvency body), severe restrictions on external borrowing, and some efforts to make federal transfers more conditional on the behaviour of local officials. As indicated above, recent legislation has also created a new federal hierarchy along the lines of seven macro-regions for helping to enforce federal laws and regulations. Additional legislation has allowed for the removal of regional governors by the president in the event of repeated violations of the law. Proposals are currently being considered in the Russian government to eliminate the only significant truly subnational tax, the regional sales tax, and for requiring subnational administrations to shift the execution of their budgets to the federal treasury.

The strategy since the second half of the 1990s to increase federal control in the regions had understandable motivations. A common feeling within the central government was that too much had been decentralised too quickly in the chaotic early years of transition, thereby justifying a certain degree of federal retrenchment. The idea of greater central control also had an immediate intuitive appeal, given evidence of deficient economic policies, wide-spread corruption, and resistance to reform in many regions. As described above, confusion and difficulties surrounding the delegation of fiscal responsibility to lower levels of government allowed the latter to pass responsibility for "bailouts" to the federal government. In a sense, the federal government has responded to this implicit responsibility with attempts to assume greater control over financial flows as well. Finally, a perceived relatively anti-reformist political orientation in many regions was sometimes viewed, in itself, as a justification for a relatively pro-reformist federal government to take more coercive action.

Nevertheless, these attempts at only increasing federal control over the regions, thereby further reducing explicit regional autonomy, have had mixed effects at best, and have been counterproductive at worst. Most important, basic incentives for responsible budgetary management and reform-oriented policies do not seem to have been positively affected by these measures to any significant degree.[19] Regions compensated for restricted formal autonomy with a greater share of informal budgetary activities. The accumulated burden of federal expenditure mandates has only reinforced poor incentives for formal fiscal responsibility, and facilitated passing even more of the blame to the federal government.

In a country as large and diverse as Russia, particularly in the context of democratisation, central control will always be imperfect and highly limited. Even if the federative structure would be entirely abandoned, similar problems would persist between federal, regional, and local branches of the "unitary" hierarchy. We propose that the fundamental improvement of incentives for subnational officials in the Russian Federation will depend greatly on economic measures, as opposed to only federal restrictions and administrative discipline. Regional and local administrations cannot be expected to feel sufficient responsibility for their own solvency and the consequences of fiscal policies unless they possess explicit autonomy within a clear and feasible budgetary framework. Some studies have argued that competition among regions operating under a high degree of fiscal autonomy has contributed fundamentally to successful development and rapid growth in a number of countries, including the Dutch Republic of the 16^{th} and 17^{th} centuries, 18^{th} century England, the United States, and, more recently, China.[20]

On the other hand, other studies suggest that decentralisation can lead to disappointing, and even disastrous, results in the event that subnational incentives remain distorted. In fact, Russia might be considered at least a partial case in point. Shleifer and Treisman (2000) and Treisman (1999b) associate strong (at least implicit) regional power in the fiscal sphere with shortfalls in federal taxation and growing fiscal imbalances during 1995-98. An appropriately designed decentralisation in Russia should therefore account for the potential pitfalls identified in the literature, as well as an account of why the high degree of informal autonomy in Russia has been so far insufficient for creating the type of engine for business and growth that is apparently the case in China. The remaining discussion in this section is devoted to a clarification of these questions.

The majority of pitfalls to the decentralisation of autonomy, as identified in the literature, concern the so-called "soft budget constraint," indicating the degree to which subnational administrations can pressure the federal government for bailouts in the event of "unexpected" financial pressures or their own threatened insolvency.[21] If the federal government is unable, for political or other reasons, to make budget constraints hard, a decentralisation of decision-making authority may not only fail to boost economic efficiency, but could also jeopardise macroeconomic stability. Given the expectation of a bailout, subnational administrations will typically have weak incentives for responsible budgetary management, perhaps even making such bailouts, together with an implied fiscal or monetary expansion, a self-fulfilling financial crisis. A number of authors have linked crises in Argentina in the 1980s and Brazil in the 1980s and early

[19] One important positive effect on incentives appears to have come from the crash of Russian financial markets in mid-1998. As a result, external borrowing constraints have tightened considerably.

[20] The literature on so-called "market-preserving federalism" and its possible contribution to development and growth continues to expand. See, for example, North and Weingast (1989), Weingast (1995), Monitola et al (1995), McKinnon (1997), Roland and Qian (1998), Jin et al (1999), Carenga and Weingast (2000), Weingast (2000).

[21] The "soft-budget constraint was first coined by Kornai (1986), and later partially formalized by Dewatripont and Maskin (1995). See also McKinnon (1997).

1990s with such soft subnational budget constraints.[22] Restricting attention to developing and transition economies, Fukasaku and de Mello Jr. (1998) find a significant negative relationship between fiscal balance and decentralisation, where the latter is defined by the share of subnational budgets in all state expenditures and the share of transfers from the federal government in subnational revenue. Similarly, Rodden (1999) finds a dependency of fiscal deficits on a high share of transfers in subnational budgets and fewer restrictions on subnational borrowing. Correcting for other factors, Treisman (1999a) finds a greater persistence of high inflation rates in countries with a federalist structure.

As described above, Russia does not exhibit a particularly high average share of transfers in subnational budgets at present, although problems persist in the "soft" adjustment of transfers to current budgetary performance. In fact, the highly centralised nature of the former system is a primary problem that has hindered government efforts to make transfers more rigid. As long as explicit revenue or expenditure shortfalls (or windfalls) depend little on the behaviour of subnational officials, it is difficult to implement, or even justify, a high degree of rigidity in transfer policies. A clearer delineation of responsibilities, together with genuine formal subnational regional autonomy and responsibility, offers a potential firm foundation for enforcing harder budget constraints through more rigid and transparent transfer policies. While some direct federal legislation may also help improve regional transfer policies to localities (see below), the effectiveness of such legislation depends critically on the creation of sound incentives at the regional level.

While we agree with the basic conclusions in Shleifer and Treisman (2000) that the power and leverage of subnational governments contributed to the growing budgetary dilemmas of the federal government between 1995-98, several points should be noted here. First, this process was not the result of any *explicit* decentralisation of either resources or decision-making authority in the fiscal sphere. On the contrary, as emphasised above, legislative and other efforts by the federal government during this period aimed at bringing subnational finance under greater central control and monitoring. After a major shift in monetary policy in the mid-1990s, which quickly phased out soft directed credits from the Central Bank, subnational administrations came to rely on their (largely informal) fiscal leverage as a means of ensuring themselves a continued flow of resources and a basis for independent policies. As indicated above, some of these activities had a negative impact on federal tax collection. Again, we believe the appropriate solution to this problem to be a formal system that would legitimise the access of regional administrations to at least a good share of these resources, but at the cost of their having to shoulder genuine political and economic responsibility.

Bird (1999) examines a problem that is highly relevant for the design of fiscal decentralisation in Russia. He stresses that developing or emerging market economies with federative structures often fall into a trap, whereby the subnational tax base is inherently inadequate to meet substantial expenditure responsibilities. Under these conditions, decentralizations have commonly been accompanied by an alarming increase in federal transfers and more political difficulties in preventing soft adjustments in their allocation. The Russian case has also witnessed the excessive delegation of expenditure responsibilities, although explicit transfers have remained relatively modest in size due to the practice of tax sharing. Due to the inherent problems with tax sharing stressed above, however, we argue below for a complete separation of taxes and tax revenues in Russia. Thus, an adequate subnational tax base to support newly delegated autonomy and responsibilities would be a critical component to the success of such a reform.

Another central question is the mechanism for delegating greater responsibility to subnational officials, which must accompany greater autonomy. A feasible formal system with clearly delineated responsibilities is a necessary, but not necessarily sufficient condition for the enforcement of responsibility. Recently, Blanchard and Shleifer (2000) have given particular attention to this problem,

[22] See Dillinger and Web (1999), Prud'homme (1995), Saiegh and Tammasi (1998), Wildasin (1997).

suggesting that it is a key difference in the nature of interbudgetary relations in Russia and China. Russian democratic institutions are still rather weak for the enforcement of responsibility for elected officials in the regions, while, until recently, the federal government has had only very limited means of punishing regional governors and administrations for poor performance or violations of federal law. This became particularly true after the introduction of direct gubernatorial elections in 1996. By contrast, China has a highly centralised political hierarchy that allows for the removal of officials from above who might be particularly corrupt or oriented toward rent-seeking. Blanchard and Shleifer argue that this threat of possible removal can be a pivotal consideration for regional officials in choosing between reform-oriented policies or allowing themselves to be captured by large incumbent firms. They therefore argue that effective decentralisation in Russia might need to be accompanied by greater political centralisation. The recent legislation allowing the president to remove regional governors would appear to be a step in exactly this direction. We agree that an effective mechanism for enforcing financial responsibility in the regions, as well as basic federal laws, is indeed a key precondition for an effective decentralisation in the Russian Federation. For this purpose, both OECD (2000) and the Russian government Programme (Programma…2000) propose the development of a clear legal concept of insolvency for a subnational administration, together with the possibility, or even necessity, or external management by a higher level of government (see below).

Other important differences between Russia and China include the extent to which the former suffers from initial conditions of transition, particularly in the burden of large loss-making enterprises that form a key part of the local social and economic infrastructure in most regions. Not only have Russian regions had to struggle with the social and political ramifications from the potential liquidation of such enterprises, but the presence of vested interests around those organisations makes Russian administrations potentially very vulnerable to capture. Exceedingly low explicit salaries of Russian civil servants, even those responsible for important financial decisions, also increases the probability of capture. China's lower level of industrialisation implies that this problem is most likely of a lower level of magnitude in many regions compared to Russia.[23]

Russian regions are subject to a much greater degree of central control over their explicit budgets and funds than are Chinese provinces.[24] We already emphasised above three primary costs of this type of central control: (a) the inability of the centre to delegate responsibility in an effective and rational manner, (b) the fact that informal policies created to evade this control are not monitored by federal organs, and (c) the necessity of building these informal policies through special bilateral relations with large incumbent firms. Given the nature of the imperfect measures aimed at increasing central control in Russian, there are additional costs as well. Litwack (2000) examines a case in which a central government cannot monitor directly the (informal) behaviour of subnational officials, but exerts control over the formal budget, setting and collecting (official) taxes and mandating expenditures. It is argued that, even with a completely benign central government, such an arrangement will lead to a higher overall tax burden on business and investment than in a case of complete decentralisation. Furthermore, the addition of central measures that increase the cost to subnational officials of conducting informal operations can even make the situation worse. The logic is as follows: the centre has an interest in increasing (monitored) subnational expenditures as an imperfect means of diverting energy and resources away from rent-seeking activities.

[23] Berkowitz and Li (1999) argue that a primary difference between Russia and China is direct taxation by different levels of government in Russia, as opposed to the indirect taxation of subnational budgets in China. They argue that the Russian case gives rise to a tragedy of the commons in taxation, as each level of government does not account for externalities created by its own taxation. While the formal Russian system based on tax sharing and central control leaves little room for such an effect, it would appear that informal relations between Russian firms and government organs probably do indeed suffer from this type of "overgrazing." In fact, this is very close in spirit to the problem of "disorganized corruption" identified in Shleifer and Vishny (1993). It is not clear to us that this effect is not as important in China, however, as the level of corruption in Chinese provinces is also believed to be high.

[24] See Monitola, Weingast, and Qian (1995), together with this paper and OECD (2000b) on this point.

The burden of these additional expenditures, however, combined with continued (although lower) rent-seeking gives rise to an overall higher level of taxes and larger regional budget. Furthermore, imperfect measures that increase the cost of informal budgetary operations can be counterproductive, as part of these additional costs might be financed through higher (informal) taxation. The presence of corruption can also convert well-intentioned efforts to monitor directly and punish rent seeking into this type of destructive "cost."

III) A General Proposal for Reform

Our proposal for reform incorporates much of the spirit of "market-preserving federalism," as proposed by. Weingast (1995) and Monitola, Weingast, and Qian (1995). These authors argue that the combination of five conditions has played a vital role in rapid economic growth and development in a number of countries: 1) a well-defined federalist system (a hierarchy of government with a clearly delineated scope of authority), 2) a high degree of regulatory authority of subnational governments in their jurisdictions, 3) the central government has a recognised authority to enforce a common market and the absence of barriers to trade and factor mobility, 4) revenue sharing and borrowing is characterised by hard budget constraints, and 5) the allocation of authority has an institutionalised degree of durability that cannot be altered unilaterally or through a coalition of governments.

We believe that an appropriate comprehensive strategy for the reform of fiscal federalist relations for Russia can exploit a number of the advantages of market-preserving federalism. Such a strategy involves simultaneous measures on six fronts: (1) the establishment of genuine regional and local autonomy within clearly defined bounds, supported by the separation of tax and expenditure functions, (2) a clarification of expenditure assignments, including legal guarantees of autonomy in subnational expenditures and the provision of an adequate subnational tax base to cover expenditure obligations, (3) a transfer to the federal government of some additional revenue and expenditure obligations that are currently a formal part of subnational budgets, with a gradual decentralisation of resources in the medium and longer term, (4) the development of a clear legal concepts of insolvency and external management for subnational administrations, (5) reform of transfer policies to make them more transparent, simple, and rigid over time, (6) an enhanced effort by the federal government to enforce free trade and factor mobility between regions and basic economic laws, such as the Law on Competition, (7) a civil service reform that significantly increases basic salaries for important figures in the administration.[25]

The reform package may fall short of the precise conditions of market-preserving federalism, most notably due to the continued, and even enhanced, strong role of direct federal taxation and expenditures. We nevertheless believe these directions of reform to be the most appropriate for Russia at the present time, and that they can activate many of the benefits of market-preserving federalism. Formal subnational policies will become independent, regional administrations will become residual claimants of their own (explicit) tax policies, in control of their own (explicit) expenditures, and in a position to equate marginal costs and benefits in fiscal policy decisions. At the same time, competition between regions for business and investment under hard budget constraints will motivate administrations to pursue reform-oriented policies. A clear and feasible budgetary system will offer a foundation for the better enforcement of laws and financial responsibility, including a crackdown on remaining informal criminal activities. As these proposed measures will substantially decrease all but criminal motivations for maintaining informal budgets, they will facilitate such an effective crackdown

[25] A basic proposal along these lines was contained in OECD (2000b) and Lavrov, Litwack, and Sutherland (2000). Later proposals in this spirit include Lavrov (2000), Khristenko (2000), and the reform of interbudgetary outlined in the economic Programme of the Russian government (Programma…(2000)), which was drafted in the spring of 2000 and approved by the government in July.

A) A Larger Federal Budget. We propose that the delegation of genuine autonomy to subnational governments should be accompanied by a relatively larger federal budget, at least in the short run. There are several reasons for this proposal. First, a good share of social expenditures and subsidies that are now the responsibility of the regions would be better managed at the federal level. Only the federal government can address the exceptionally high degree of disparity in income, wealth, and revenue potential between regions. In addition, the creation of subnational autonomy in the context of competition for business and investment (and associated externalities) implies that purely subnational outlays on social policy would likely be inadequate, with negative social and political consequences. Despite the high regional disparities, absolute levels of federal transfers remain quite low in Russia, as indicated in Figure 2.[26] An enhanced direct role for the federal government in social policy will minimise the need to increase general-purpose transfers. Second, making the federal government directly responsible for its own expenditure mandates should support a much more rational process for the adoption and nullification of such mandates. Third, the creation of institutions to support strong financial responsibility and hard budget constraints at the subnational level, including the training of qualified personnel, will take some time. Under these circumstances, together with the imperative of maintaining macroeconomic stability and control, we believe that immediately entrusting subnational governments with half of state revenues and expenditure obligations would be unwise. As institutions for supporting autonomy and financial responsibility develop, competition between regions ensures, and the problem of poverty subsides, the share of subnational finance should gradually expand as the federal budget shrinks.

B) Subnational Autonomy: Expenditures. Further basic legislation is needed for the creation of genuine autonomy on the expenditure side of subnational budgets. First, the Budget Code needs to be amended in a manner that not only assigns various expenditure categories to lower levels of government, but guarantees subnational administrations autonomy over the actual size, breakdown, and execution of purely regional or local expenditures. Without such guarantees, even expenditure categories currently recognised as only regional or local are typically determined on the basis of rigid federal norms and requirements. As we have argued, freedom over the determination of expenditures is currently one of the primary motivations for the reliance on informal budgets. Second, for those categories of expenditures where responsibility is shared between the federal and subnational governments (Article 72 of the Russian Constitution), separate laws should clarify a similar delegation of autonomy for various expenditure subcategories. In general, autonomy should rest with that level of the government responsible for financing the expenditure outlays. In some important cases of joint responsibility such as education and health, (voluntary) matching federal grants might be appropriate, conditional on meeting certain minimal federal standards for the quantity and quality of services provided.

It is also critical that subnational administrations be relieved of the burden of unfunded federal mandates. A large number of these mandates need to be legally nullified, while the financial responsibility for the remainder should be shifted to the federal budget. Further legislation should explicitly forbid the future delegation of unfunded or partially funded mandates. For remaining mandated social expenditures, this leaves two primary options: financing expenditures directly from the federal budget or allocating federal grants to the regions to cover their costs. The latter option allows for the possible exploitation of administrative or informational advantages at the subnational level, and for minimising the short-term disturbance to current expenditure responsibilities. A major disadvantage, however, is the potential bargaining and consequential "softness" in the determination of the appropriate size of these grants for

[26] Transfers are low not only relative to most other developing or transition economies, but relative to most developed economies as well. Although Germany appears at close to the same level as Russia in Figure 2, this is highly deceiving, as a large share of German transfers are directed horizontally across regions and, for this reason, are not classified as federal transfers in official data.

different regions under uncertainty.[27] In the Russian Federation, there already exists a strong presence of federal organs, including a relatively developed treasury system, while most regional administrations have yet to develop effective methodologies for targeting assistance on their territories. The combination of these factors suggests a strategy of incorporating a large share of these expenditures directly into the federal budget, although perhaps employing grants during a few years of transition in the interest of avoiding too large a shock to existing arrangements. Particularly important local informational and administrative advantages would justify a continued use of grants for some expenditure categories.

The federal regulation and determination of salaries for regional and local civil servants should also be terminated. This practice can be viewed as a particular type of unfunded federal mandate that accounts for 20-30 per cent of subnational expenditures. The provision of genuine financial autonomy and responsibility, sufficient subnational revenue sources, and stable federal transfer policies should create conditions for the efficient decentralised determination of salaries and staffing of regional and local civil servants. In the event that this policy shift presents too great a shock to some regions in the short run, some limited federal assistance might supplement local efforts to ensure minimum compensation for civil servants. The amount of this temporary assistance should be determined on the basis of norms applicable to all regions, however, and not on the actual size of personnel.

The quality of subnational expenditures can be promoted at the federal level by drafting a list of basic standards for the evaluation of “best practices” in subnational budgetary management and fiscal policy. Rankings of subnational administrations according to these standards should be made public information and widely disseminated to the Russian electorate and potential investors.

In the period of transition to a clearer division of expenditure assignments between various budgets, temporary disturbances can be avoided, to some degree, through a strategy that trades assignments simultaneously in as balanced a manner as possible. For example, at the same time that the federal government is assigned responsibility for social policies to assist low income families, regions can receive the responsibility for financing some professional schools on their territories.

C) Subnational Autonomy: Taxation. The extensive use of revenue sharing in the Russian Federation has helped limit the overall size of federal transfers. Some specialists even recommend tailoring these sharing rules specifically to individual regions as a means of still further decreasing a dependence on explicit transfers (Leksin, Shvetsov (1999)). On balance, however, the institution of tax sharing has had far greater costs than benefits. As emphasised above, as long as subnational administrations are not dominant residual claimants for their tax revenue, they will have a strong incentive to shift their activities off budget, with all of the negative implications identified above. In general, McKinnon and Nechyba (1997) make a forceful general case that a clear separation of tax and expenditure assignments is an important precondition for the enforcement of financial responsibility and hard budget constraints. Tax sharing inherently contains a strong element of political bargaining that is, in itself, a source of “softness.” Current arrangements that allow the federal government to alter sharing rules on an annual basis set the stage for a highly politicised and inefficient bargaining process.

We propose that the current system of tax sharing should be replaced by the clear assignment of every tax to one particular budget. In addition, subnational administrations should be delegated much more flexibility in the choice of taxes and their respective rates. Only under such conditions can regional and local officials reasonably be held responsible for the state of their budgets and economies. The degree to which subnational administrations should be completely free to create their own taxes and determine their own tax bases is a difficult question in the Russian context. As the new Tax Code currently prescribes a

[27] From this point of view, a number of authors have recently raised serious questions on the efficacy of federal grant policies. On this subject, see McKinnon and Nechyba (1997) and Inman and Rubinfeld (1997).

highly restricted list of taxes, it might be most constructive to work within this framework at present, but to amend the list to ensure an appropriate tax base, freeing subnational administrations to set the rates of their own taxes. Subnational autonomy can be cemented by the development of separate regional and local tax service bodies and treasury systems. In the medium and longer term, as institutions of subnational finance and responsibility become more developed, regions and localities could also be delegated increasing authority for the creation of their own taxes. Along with the elimination of tax sharing and the creation of subnational budgetary autonomy, the Budget Code should also be amended to eliminate the current norm that dictates a 50/50 division of overall state revenue between the federal and consolidated regional budgets.

As stressed above, a critical ingredient for the success of this reform is the provision of an adequate subnational tax base for covering basic expenditure responsibilities, at least in regions that are not exceptionally poor. Some poorer regions will unavoidably remain highly dependent on federal transfers, although the provision of flexibility in tax policy at the margin can still support the implementation of a relatively rigid transfer methodology in the spirit of current reforms. Conventional wisdom assigns taxes to regions and localities on factors that are relatively immobile or largely resident-based, so as to avoid externalities and other problems in collection.[28] As indicated in the previous section, however, Bird (1999) makes a forceful case that regions need to have at their disposal some significant tax such as a regional sales tax or (separate) VAT. The recently-introduced regional sales tax represents an important relatively stable and collectable source of income at the subnational level in Russia, and can play a critical role in supporting the creation of genuine autonomous regional budgetary management and fiscal policy. While such a tax is source rather than resident-based, potentially creating externalities for other regions, these externalities can actually play a positive role in disciplining economic policy, as indicated above. Although explicit subnational budgets should decline in size along with a comprehensive set of measures that shifts some major revenue sources, such as the (federal) VAT, to the central government, subnational expenditure obligations will also become more modest.

C) Subnational Responsibility and Debt. Section II of this paper stressed that the delegation of genuine (enforceable) responsibility along with autonomy is a key ingredient of a successful decentralisation of autonomy in Russia. The system of the 1990s had too weak a mechanism for holding subnational officials responsible for their solvency, effective budgetary management, and the observance of federal laws and regulations. Part of the problem was the highly centralised nature of the formal system, which made the delegation of responsibility extremely difficult and even irrational. The creation of a feasible system with clearly delineated responsibilities and a separation of taxes is a vital precondition for subnational accountability. Furthermore, the mechanism for holding subnational officials responsible for their activities requires further strengthening. The recent law that allows the president to remove heads of administrations in the event of repeated violations of federal law has already increased the leverage of the federal government over the regions. In addition, financial responsibility can be supported by a clear legal concept of insolvency for a regional administration, together with the possibility of temporary external management by a higher level of government. While such conditions are a bit unusual in practice for federations, we believe that the specific difficult conditions of Russia, including the weakness of still emerging democratic institutions, support the rationality of such a reform. We also believe that a number of other federations might profit from such a condition. Other than insolvency, external management could also be triggered by other gross violations of basic norms, laws and budgetary responsibilities.

As described above, the rapid accumulation of subnational debt evolved into a debt crisis and widespread insolvency among Russian regions. Many Subjects of the Federation became insolvent even before the federal government in August 1998, and a large share of regions remain insolvent today. In the aftermath of this crisis, most regions are highly constrained from borrowing on capital markets. As long as the

[28] See, for example, Oates (1972).

federal government is clear to potential creditors that it does not intend to insure subnational debt, these constraints should remain tight even in the absence of formal restrictions on the ability of administrations to issue debt. Nevertheless, the ability of subnational administrations to pressure organisations on their territories for finance may justify the temporary additional presence of formal restrictions in this area. But most of these restrictions should be lifted gradually over time in the interest of the healthy development of regional credit markets and competition among administrations for high credit ratings. In any case, subnational administrations will retain ample informal means for borrowing, most notably through affiliated organisations.

D) Federal Transfers A clear delineation and separation of tax and expenditure functions, as proposed above, will complement current efforts to make the allocation of federal transfers more transparent, targeted, and independent of current budgetary considerations, and to concentrate transfers more effectively in the poorest regions.

E) Local Government Autonomy. Given the rather large size of many Russian Subjects of the Federation, local state autonomy is a potentially vital component of a strategy for creating and defending subnational autonomy. To a significant degree, the very same principles applied to the creation of regional autonomy can be generalised to the local level: guaranteed and clarified autonomy over certain expenditure categories, a sufficient tax base and freedom to set taxes, freedom from unfunded mandates, etc. Existing laws such as the Budget Code and Tax Code should be amended to recognise explicitly a three rather than two-tier system, as is the common case at present. But the question of local autonomy in Russia requires the consideration of some additional complex issues.

As stressed in section II, types of municipalities and other local administrations in Russia are numerous, ranging from relatively large cities with well-defined budgets and tax bases to small rural communities that are essentially a part of the regional budget. Local administrations can be municipalities themselves or parts of larger municipal units. The current condition in the law on local self-government that allows any populated area declare itself a municipality has added to the confusion somewhat, as the wide variance in types of municipalities complicates efforts to apply any uniform conditions of autonomy and responsibility. In fact, the legal status of a municipality is not even that of a government organ, which alone creates technical difficulties in assigning local administrations any sort of government autonomy.

A potential solution is a new administrative division of regions into larger units of local state power. In essence, these larger units (large cities and former Soviet districts (*raiony*) already exist. Some have the status of municipalities themselves, while others are simply administrative subdivisions of the regional government that oversee the operation of smaller municipalities. Basic federal legislation could provide a framework for determining or formalising this regional territorial division, accounting for public opinion and stating procedures for choosing and electing local state officials. In this case, federal legislation could guarantee certain basic taxes and budgetary autonomy to local governments in the manner described above. Existing conditions that allow any populated area to declare itself a municipality within a local government territory should remain, including provisions for revenue sources and financial obligations. But functions that technically require state autonomy (schools, health, etc.) could be handled at the local level by the newly empowered local bodies. Smaller municipalities would also contract and interact primarily with this lower level of state power.

Under current Russian conditions, the success of a reform for the creation of local government autonomy and responsibility will unavoidably depend strongly on the incentives of regional administrations. When Subjects of the Federation themselves are placed under conditions of explicit financial autonomy and responsibility, they will have a far greater incentive to create similar conditions within their regions for local administrations. Thus, measures to straighten out relations between the federal government and

Subjects of the Federations should be understood as a crucial part of the realisation of effective local self-government.

The Economic Programmeme of the Russian Government of 2000 and Prospects for Reform

The year 2000 may have been a decisive turning point for the reform of fiscal federalist relations in the Russian Federation. In its Economic Programme (Programma…2000), the Russian government approved a comprehensive reform for fiscal federalist relations that is very consistent with the outline above and OECD (2000b). The Programme states clearly that "subnational government organs should have authority, and a significant degree of autonomy, in the conduct of fiscal policy within their territories.[29] Amendments to the Budget Code are proposed for a clarification of expenditure assignments, a delegation of genuine expenditure autonomy, and an association of full financial responsibility for all mandates with the level of government from which they emanate. The Programme contains a declared goal of shifting from tax sharing to a principle of "one tax – one budget," together with possible future agreement on the creation of subnational treasuries and tax collection agencies. A concept of insolvency for subnational administrations is to be developed along with a new law on external financial management and a corresponding necessary amendment to the Budget Code. The VAT is due to become a completely federal tax, while the 15 per cent that formally accrued to regional budgets will make up a "Compensation Fund" for the continued finance (at the regional level) of some large remaining mandates. In the medium term, at least part of the finance of these mandates is to be shifted to the federal budget and administered through the federal treasury. The reform of transfer policies is to continue, including the elimination of so-called "mutual settlements" and the introduction of matching grants for health and education based on minimal federal standards for the quantity and quality of services provided. Other parts of the Programme emphasise measures to ensure a unified economic territory within Russia and eliminate remaining barriers to labour, capital, and other factor mobility. The Programme also hints at a possible reform of the structure of local government.

The realisation of parts of this Programme has already begun. The draft Budget for 2001 makes the VAT a 100 per cent federal tax and assigns 99 per cent of the income tax to consolidated regional budgets. This can be seen as at least a step in the direction of the separation of taxes by budgets. The draft Budget also foresees the creation of the Compensation Fund for covering the costs of two large mandates: child allowances and benefits for invalids. One mandate concerning privileges for military personnel and the police has been incorporated directly into the federal budget. The methodology for the allocation of the FFSSF is to be made virtually independent of recent budgetary performance beginning in 2001.

Nevertheless, the reform of fiscal federalist relations continues to be a source of some uncertainty and controversy in the Russian Federation. This controversy concerns parts of the planned reform in fiscal federalist relations outlined above, the consistency of this reform conception with other parts of the Government Programme, and problems in the particular sequencing of measures for implementation.

Some proposals within the Russian government on tax reform, including parts of the Economic Programme, appear inconsistent with the creation of subnational autonomy. Current proposals promise to make virtually all major taxes federal, placing subnational budgets in even greater dependence on taxes and revenue sources directly determined by the federal government. This includes a proposed elimination of the regional sales tax and the continued predominant finance of subnational budgets from revenue sharing of federal taxes. As indicated in section II of this paper, a number of already implemented recent measures have actually further limited, rather than expanded, subnational autonomy in taxation. As we have argued, this autonomy is a critical element for the realisation of the entire reform strategy for fiscal federalist

[29] Programma…(2000), Section 2.3.1, par. 5

relations in Russia. Without such autonomy, other measures aimed at improving subnational finance through increasing responsibility and cracking down on informal budgetary activities are bound to fail. As discussed above, maintaining a strong purely regional revenue source, such as a general sales tax, is also a key element for a successful decentralisation of autonomy.

Parts of the Economic Programme on social policy suggest that autonomy and responsibility for most social expenditures might be delegated to the regional (Subject of the Federation) level. Under such an interpretation, these measures would be inconsistent with the proposal that the federal government takes a greater direct responsibility in this area. As we have stressed, in the context of regional autonomy and competition among regions for business and investment, purely subnational social outlays would very likely decline below adequate levels in many regions. With serious problems of poverty in many regions, this would have strong social and political implications, with the federal government likely to end up with a good share of the responsibility in any event. In fact, the combination of a centralisation in taxation, as described above, with the delegation of social policy to lower levels of government could be a particularly detrimental mix, compromising vital efforts to de-politicise transfer policies and make subnational budget constraints hard. The absence of hard budget constraints, on the other hand, would negate the benefits of budgetary autonomy. We have emphasised throughout this paper our belief that the creation of formal subnational autonomy, together with the improvement of incentives for responsible and effective subnational fiscal policies, makes imperative a central role for the federal government in the regulation and support of social policy.

Despite the momentum within the government for the elimination of unfunded federal mandates, little has been done so far to relieve their burden on subnational budgets. Few of the enormous number of accumulated mandates have been nullified or granted federal financial support, while the draft budget for 2001 continues the explicit requirement that regions themselves finance an expensive mandate on privileges for war veterans. Furthermore, the federal government has mandated that regions and municipalities increase salaries in the budgetary sphere by 20 per cent in 2001. Hopefully, the final elimination of unfunded mandates and the protection of subnational governments from future mandates can be achieved before the drafting of the federal budget for 2002.

This paper argues that the creation of explicit budgetary autonomy is central to the success of the overall reform Programme, the improvement of the environment for business and investment, and the achievement of sustainable stability and growth. There exist no rational means for holding regional and local officials responsible for budgetary management if they have little of no decision-making authority. Under current arrangements, subnational administrations will continue to realise a high degree of autonomy through various informal means in a manner that encourages corruption and is harmful to the overall business environment and fair competition. Genuine responsibility can be delegated only together with an explicit recognition of autonomy. We propose a federalism for the case of Russia that may not exactly satisfy the criteria of market-preserving, but is close enough in spirit to be market-creating.

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