Fiscal Federalism in the Russian Federation: Problems and Reform Options*

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1. Introduction

Since the mid-1980s, the Russian government has experienced a major regional decentralisation of economic and political authority. To a large degree, this process represented a reaction to the hyper-centralised nature of the former Soviet system. A significant degree of autonomy at lower levels of government has now become a political reality that would be exceedingly difficult for the central government to reverse. Accordingly, the building of an explicit system of fiscal federalist relations for the feasible and efficient division of authority, revenue, and expenditure obligations between the federal, regional (Subject of the Federation) and local levels of government has been a central task in the Russian economic and political transformation process. A number of the changes in interbudgetary relations since the outset of transition look encouraging on paper. Beginning from a legacy of almost complete centralisation in fiscal authority, revenue, and expenditure, the relative proportions of federal and consolidated regional budgets have quickly converged to those in many other developed federations. Much more uniform regulations and conditions for most regions are replacing the chaotic bilateral agreements that characterised earlier years of transition. While federal transfer policies have suffered in the past from a lack of clarity and transparency, recent reforms to address these problems have been at least partly successful.

Nevertheless, despite some progress in reform, the actual state of fiscal federalist relations in the Russian Federation remains in a state of disarray, and continues to present a primary obstacle to successful economic transition. Despite relatively large subnational budgets on paper, the formal fiscal federalist system remains highly centralised, with a large share of regional and local revenue and expenditures being dictated by laws and regulations of higher levels of government. This high degree of centralisation in the formal system stands in direct contradiction to the significant *de facto* autonomy that subnational administrations have acquired in the reform period. Furthermore, the combined burden of these explicit laws and regulations often makes their fulfilment unfeasible in practice. These contradictions have multiple costs for the Russian economy and reform process. First, they have provided a context where subnational officials can essentially absolve themselves of much of the responsibility for formal budgetary management. Second, it has induced subnational administrations to exercise their *de facto* authority in fiscal policy largely through means that circumvent formal budgetary relations. Important policy tools in this regard include various money surrogates, extrabudgetary funds and accounts, arrears, direct participation in economic organisations, and the accumulation of subnational debt. The informal nature of these policies, combined with very low civil servant salaries, also encourages corruption. Finally, this state of affairs leaves rather weak incentives with subnational administrations for the adoption of economic policies consistent with strong incentives for business and investment. Obstacles to economic reform stremming from regional policies have been highlighted in a number of studies (OECD (1997), Shleifer and Treisman (1999)).

The Russian system of fiscal federalist relations is in need of fundamental reform. This reform should involve the explicit recognition of much of the already *de facto* autonomy of subnational administrations, a clear and feasible delineation of revenue and expenditure assignments, and genuine financial responsibility

1 This paper summarises the main arguments of Chapter 3 of the *OECD Economic Surveys: The Russian Federation: 1999-2000* (OECD (2000)). This survey was prepared in co-operation with the Russian government and a number of administrations of Subjects of the Federation. Most of the data comes from primary or official sources. For figures lacking a citation in the present paper, the reader is referred to OECD (2000).

for budgetary management at the subnational level. In the present context of the Russian economy, this delegation of autonomy and responsibility might also be accompanied by somewhat larger explicit federal budgets and expenditure responsibilities. Subsequent sections of this note place Russia in the context of recent theoretical literature on fiscal federalism, describe the nature of existing interbudgetary relations, and outlines a basic needed direction of reform. A more detailed presentation of this material can be found in OECD (2000).

2. Fiscal Federalism and Russia: Basic considerations

While classical theoretical studies of fiscal federalism focussed on an efficient division of fiscal control in a static economy (Musgrave (1959)), more recent research addresses the relationship between fiscal federalist relations, economic growth, and reform. North and Weingast (1989), and Weingast (1995)) relate a concept of "market-preserving federalism" to the historical period of rapid growth in Great Britain and the United States, while Monitola, Qian and Weingast (1995) and Parich and Weingast (1997) apply this concept to the cases of China and India. "Market-preserving federalism" is roughly defined as concrete and unalterable rules that severely limit the tax authority of the federal government, while central authorities have a recognised power to enforce free trade and factor mobility between regions. The theory proposes that the highly limited tax authority of the federal government prevents expropriation of private interests by the centre, while competition between regions in the context of trade and factor mobility disciplines subnational governments into adopting policies conducive to business and investment. The high powered incentives thus created support high investment and the "big push" toward economic growth. The existing Russian system involves the gross violation of these conditions as well as a policy environment that is not highly conducive to investment and growth, raising the question as to what extent future reform of fiscal federalism in Russia should attempt to embody the spirit of market-preserving federalism.

The type of decentralisation associated with "market-preserving federalism" raises a number of questions for the case of the Russian economy, however. A first concern, emphasised by Fukasaku and de Mello Jr (1997), is a potential loss of control of state finance, leading to negative consequences for macroeconomic stabilisation. Indeed, Shleifer and Treisman (1999) argue that fiscal decentralisation in Russia has contributed to chronic problems in federal tax collection. In recent case studies, Freinkman and Yossifov (1999) find a correlation between decentralisation and poorer budgetary performance at the local level in Russia. In a series of papers, Treisman (1999a, 1999b, 1999c) links fiscal decentralisation with higher inflation, corruption, and a possible policy bias toward multi-regional firms. Highly uneven resource endowments across regions, Russia's exceptionally large geographical size, severe weather, and a poor transportation infrastructure potentially weakens the disciplining effect of free trade and factor mobility on regional policies. Large regional income disparities suggest a strong federal role for smoothing inequality. Most Russian regions inherited an inefficient structure of production from the Soviet period. Given the limited terms of political administrations, and the powers of various interest groups, regional and local officials may be quite reluctant to undertake reform that trades off current welfare for the future benefits from restructuring. Russia needs a federalism that is "market-creating" as well as "market-preserving."

Due to the above considerations, Russia will most likely require a strong fiscal role of the federal government for many years to come. The challenge is to construct a feasible fiscal federalist system that not only incorporates a strong role for the federal government, but also allows for some of the advantages suggested by "market-preserving federalism," supporting incentives for responsible and reform-oriented polices at lower levels of government. This would entail, first and foremost, greater fiscal autonomy and responsibility at the regional and local level, along with heightened efforts to eliminate barriers to trade and factor mobility across regions.

3. The Russian system of fiscal federalism: formal arrangements

The evolution of fiscal federalist relations in Russia during the early years of economic transition was quite chaotic. Regions continually lobbied for greater revenue, while the federal government responded by pushing expenditures downward (Wallich (1994)). Recent years have witnessed important progress toward the creation of uniform conditions for all regions, although special bilateral agreements remain in certain cases.[2] But interbudgetary relations continue to be highly problematic.

While roughly half of all consolidated government revenue accrues to subnational budgets, less than 20 per cent of subnational tax receipts come from sources that could be considered autonomous in any real sense. The remaining 80 per cent of revenue derive from taxes either regulated entirely by higher levels of government, or subject to very tight regulations that make them such for all practical purposes. The latter includes the regional profit tax (20 per cent of regional revenue) that is virtually always set at the fixed federal ceiling. Taxes that account for the remaining 20 per cent of revenue are also typically subject to numerous restrictions. Thus, the significant decentralisation of revenue to subnational budgets has not been accompanied by a similar decentralisation of formal fiscal authority on the revenue side of the budget. On the contrary, recent trends have been in the opposite direction. Most recently, the first part of the Tax Code has reiterated severe restrictions on the type and number of taxes that can be employed at subnational levels.

If the formal division of revenue between federal and consolidated regional budgets is at least converging to some degree of uniformity across most Subjects of the Federation, this is not yet the case for relations between regional and local governments. Regional administrations continue to set highly differentiated rates for sharing revenues with local budgets. These rates are also exceedingly unstable and continually adjusted for the purpose of equalisation, a process that supports weak incentives for responsible budgetary management at the local level (Zhuravskaia (1998), Alexeev and Kurliandskaia (1998), and Eigel (1999)). A law on local self-government from 1997 attempted to address this problem, prescribing 3-year minimum average norms for revenue sharing between regional and local budgets. This law appears to have had little effect in practice, however, as regional administrations have typically preserved a maximum degree of flexibility by setting initial individual (and thus average) norms very low, while compensating through more active transfer policies. Empirical evidence since the implementation of this law also continues to document a high degree of instability in sharing norms (OECD (2000)).

The legal framework for expenditure assignments has been highly problematic throughout the transition period.[3] In the early years of transition, many expenditure responsibilities were transferred to subnational levels without a simultaneous consideration of revenue sources. This could take the form of explicit legislation or a simple refusal of the federal government to finance various budgetary categories. While the mid-1990s brought some progress in the adoption of basic principles for the division of expenditure assignments, many areas of responsibility continue to remain ambiguous. The logic behind the formal division of some expenditure assignments, including subnational responsibility for virtually all social expenditure categories, is also questionable for the case of Russia.

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[2] Important cases governed by bilateral agreements are Tatarstan, Bashkortostan, and Sakha (Yakutiia), although such agreements in recent years have become a bit closer to the rules applied to other Subjects of the Federation. A number of other regions have also concluded special “Agreements (Soglasheniia)” with the federal government that grant them special fiscal privileges. But it appears that such privileges have not been implemented in practice. See OECD (2000) for details.

[3] The first comprehensive study on fiscal federalism in the Russian Federation (Wallich (1994)) particularly emphasised the lack of clarity and legal foundation for expenditure assignments.

If Russia began to make progress in clarifying expenditure assignments in the mid-1990s, more recent trends have again become worrisome. The cumulative impact of numerous unfunded federal expenditure mandates has essentially crippled subnational budgets. Since 1993, federal mandates without specified sources of funding are legally only of a “recommended” nature. This clause has been upheld in the new Budget Code. Nevertheless, in most cases, the courts have continued to view the financing of these mandates as obligatory. The position of the courts derives from ambiguous wording in federal budgetary documents to the effect that the general calculation of federal transfers accounts for mandates. In reality, transfers do not come close to accounting for existing mandates. While transfers account for less than 2 per cent of GDP, and are mainly directed at revenue and income smoothing, the estimated combined burden of the 25 most important unfunded federal mandates is 8 per cent of GDP (60 per cent of consolidated regional revenue). These 25 mandates were fulfilled on average by only 30 per cent in 1998. In this context, it has become quite common for a group of eligible budgetary recipients according to a federal mandate to win a decision through the courts that blocks the accounts of local authorities until the complete satisfaction of their claims. As the number of federal mandates has mushroomed in recent years, only recently has the central government or legislature given any attention to the problem of repealing previous mandates, many of which are not longer treated as “serious” by either central or subnational authorities. The combined estimated burden of all federal expenditure mandates that were identified as existing by at least one region in a 1999 survey of 68 Subjects of the Federation is over 20 per cent of GDP (170 per cent of consolidated regional revenues).

In addition to mandates, a number of other federal regulations directly affect the expenditure position of subnational governments. These include numerous federal instructions and norms on the number and type of budgetary organisations, civil servants, and civil servant wages. Changes in the official minimum wage by the federal government also have strong implications, first and foremost, for subnational governments, as a large number of social expenditures are linked to the minimum wage.

Federal transfer policies have undergone some important reforms in recent years. The vast majority of federal transfers have been transferred to a specific Fund for the Financial Support of Subjects of the Federation. This fund is generated from a fixed share of federal tax revenue and allocated according to a formula that is being made more rigid and less dependent on the past tax and expenditure performance of the region. The expectation that federal transfers will change to accommodate changes in regional budgetary performance has been identified in many studies as a disincentive for responsible subnational budgetary management (Lavrov (1997), Martinez-Vazquez and Boex (1998)). Nevertheless, the actual determination of transfers during the course of the budgetary year remains highly politicised, and can deviate significantly from that prescribed by the formula. Given the highly centralised nature of the formal fiscal federalist system, the delegation of social expenditures to the subnational level, and the large regional diversity of the Russian Federation, the separation of the determination of transfers from considerations of current regional budgetary fulfilment is inherently difficult.

4. The outcomes of the system

Despite the highly centralised nature of the formal interbudgetary relations, subnational administrations do have a large degree of *de facto* autonomy and influence in their jurisdictions. This influence can be exercised through various means, including control over licensing, water supply, various types of grants or fines, protection from bankruptcy, inspections, guarantees for commercial loans, and direct participation in the capital of numerous economic organisations. This leverage over economic organisations provides subnational administrations the *de facto* authority to design their own independent economic policies. But the highly centralised, and often unfeasible, formal system distorts incentives for responsible subnational policies from several points of view. For the realisation of their own fiscal policies, subnational administrations must rely largely on informal means that circumvent the system. This includes a heavy (and often costly) reliance on various money surrogates, extrabudgetary funds and accounts, and the accumulation of subnational debt. The lack of formal fiscal autonomy also provides a context where subnational officials can absolve themselves of the full responsibility for (formal) budgetary management. The inherently informal nature of subnational fiscal policy also directly encourages corruption.

The widespread use of money surrogates in subnational budgetary operations has become a primary means of conducting relatively independent regional and local fiscal policies. This primarily refers to various forms of debt or payment offsets and bills of exchange. Money surrogates came to account for a majority of budgetary revenue to consolidated regional budgets in 1998, before falling to roughly 40 per cent in 1999. Shares of surrogates in expenditures are similar. The various advantages afforded to subnational administrations from the use of surrogates are summarised in detail in OECD (2000) and more briefly in Litwack and Sutherland (2000). These advantages include more general control over resource allocation, the freedom to employ (implicit) tax exemptions, fines, or expenditure reductions without legislative approval or monitoring of the Anti-Monopoly Ministry, a higher share of tax revenue remaining at the subnational level, and the implicit reduction of budgetary targets. Surrogates are also a convenient mask for illegal or corrupt activities, as they are not monitored and leave no real paper trail.

Various extrabudgetary funds and accounts are another important source for the conduct of independent fiscal policies at the subnational level. This includes three main types of extrabudgetary facilities: territorial branches of state (federal) extrabudgetary funds, specific funds of subnational authorities, and special off-budget accounts *(sumy po porucheniiu*). Some of the territorial branches of explicit state (federal) extra-budgetary funds, including medical insurance, employment, and road funds, are allocated with more authority and discretion by subnational authorities than is the explicit budget. A preference for diverting revenue into these funds in recent years is reflected in their growing size relative to the explicit budget. Although subnational governments face legal restrictions in the creation of their own extrabudgetary funds, a number of loopholes exist. One common loophole is the creation of “voluntary” funds, along with side penalties or rewards that depend on the size of “contributions.” No comprehensive information exists on the size of these funds. In a recent regional survey, 41 of 68 Subjects of the Federation admitted to having such funds. There also appear to be cases where the size of these funds actually approaches the size of the explicit budget itself. Finally, the so-called off-budget “accounts (sumy po porucheniiu)” contain funds from various sources, including off-budget payments such as fines, and transfers of certain “unused” portions of budgetary funds. In the recent survey of 68 Subjects of the Federation in 1999, administrations reported an average of 37 such accounts per region, with holdings equivalent on average to 5 per cent of budgetary revenue.

Problems in fiscal federalist relations and distorted incentives of regional and local administrations are also visible in the implementation of the explicit budget. A trend toward greater subnational budgetary imbalance, debt, and loan guarantees culminated in the overall insolvency of a large number of regions in the aftermath of the August 1998 crisis. Official figures show the consolidated regional budgetary deficit rising gradually to 1.4 per cent of GDP in 1997, before falling to 0.3 per cent in 1998 in the context of greatly tightened borrowing constraints. But this measure of budgetary balance fails to reflect the true extent of the deficit overhang. Primary means of fulfilling (cash) subnational budgets have been expenditure sequestration or the accumulation of budgetary payment arrears. An alternative accruals measure of the consolidated regional deficit that subtracts tax arrears but adds budgetary payment arrears, including those implied by the underfulfilment of the 25 most significant federal mandates discussed above, reaches over 5.5 per cent of GDP in every year for the period of 1996-98 (OECD (2000)). Similarly, while official statistics show subnational domestic debt accumulating to 2.2 per cent of GDP by 1 January 1999, other (rough and incomplete) estimates based on survey data, which include additional categories of debt and loan guarantees, reach as high as 6 per cent of gross regional product (OECD (2000)). Furthermore, 35 per cent of this debt and guarantees was reported as being in arrears as of 1 January1999, reflecting the default and effective insolvency of numerous regional administrations.

5. A Direction for Reform

The system of fiscal federalist relations is in need of fundamental reform. The current highly centralised system encourages subnational administrations to circumvent formal arrangements in the conduct of their own fiscal policies, while also absolving themselves of responsibility for formal budgetary management. This state of affairs also hinders the development of general incentives at the regional and local level for policies conducive to investment and restructuring. In a certain sense, measures taken by the federal government in recent years to address problems in subnational policies have treated the symptom rather than the disease. The general strategy has been to introduce still greater formal restrictions and discipline, including limitations on the number and types of taxes at the subnational level, ceilings and bans on debt instruments, direct pressure to reduce the use of money surrogates, and the further delegation of federal mandates. This has re-enforced the already overcentralised nature of the formal system, further encouraging regional and local administrations to continue to find "creative" solutions for exercising their real fiscal authority. The sheer size of Russia, and the related informational advantages and *de facto* power of subnational officials, imply that the federal government cannot hope to rectify this situation by relying only on disciplinary measures and restrictions.

While the particular situation in Russia continues to support a strong role for the federal government in taxation and budgetary expenditures, some of the important advantages of market-preserving federalism can still be realised through measures to increase the dependence of subnational budgets on the overall economic performance of the region, create real responsibility for financial solvency, and combat barriers to trade and factor mobility between regions. In the Russian context, the recognition of genuine autonomy at the subnational level is a prerequisite for the effective realisation of such measures. We propose that a successful strategy for reform of fiscal federalist relations should be based on the following basic considerations:

- The system should provide a feasible and realistic context for interbudgetary relations, involving the explicit recognition of already substantial *de facto* fiscal authority of regional administrations, although within clearly defined bounds. This includes the right to introduce regional and local taxes, conduct independent fiscal policies, and become free from the burden of unfunded federal mandates. This independence could be solidified through the creation of separate tax services and treasury departments for different levels of government.

- Along with this greater fiscal authority should be a delegation of genuine responsibility for budgetary management. In the Russian context, this should include the development of concepts of insolvency and bankruptcy for subnational financial administrations. This would allow the introduction of temporary administration by a superior level of government in the event of insolvency and a detailed legal investigation that could hold individual officials responsible for improper budgetary management.

- The particular context of the Russian Economy today suggests accompanying greater explicit fiscal autonomy at lower levels of government with an increase in the relative size and budgetary responsibilities of the federal government. This would have the effect of preventing greater subnational autonomy from threatening overall macroeconomic financial control, improving the effectiveness of transfer and social policies aimed at smoothing regional differentiation, and requiring the federal government to assume responsibility for its own expenditure mandates.

The development of greater independence of local from regional budgets is an important and complicated direction of reform. As indicated above, previous efforts by the federal government to create a legal framework for greater local autonomy have been largely unsuccessful. In additional to specific problems in existing laws, the very high variance in local conditions, combined with the *de facto* power of the regional administration, makes federal attempts to impose uniform standards generally quite difficult. A prerequisite to the solution of this problem is the creation of better incentives at the regional level of government for responsible fiscal management, corresponding to the direction of reform outlined above.

OECD work in 2000 is concerned with a more specific examination of feasible options for Russia in the direction of a workable fiscal federalist system consistent with the above principles. The goal is to improve incentives at lower levels of government for responsible economic policies, better exploit the benefits from decentralisation and the diversity of Russian regions, and bring much of the current underground web of fiscal relations out into the open. A crucial consideration for the case of Russia is the political feasibility of such a fundamental reform, which will depend on the support of a large number of regional administrations. The attractiveness of the package in the eyes of the regions involves a trade-off. On the one hand, greater subnational fiscal autonomy and freedom from a number of centrally-imposed expenditure obligations will be highly attractive to most regions. The price of this package is an agreement to a relatively larger federal budget and, consequently, federal revenue share.

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