

FISCAL DECENTRALIZATION IN RUSSIA: ECONOMIC PERFORMANCE AND REFORM ISSUES

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I. Introduction

Similar to developments in many Central and Eastern European countries during the last decade of transition, Russia has carried out a series of comprehensive reforms of its system of inter-governmental fiscal relations, against the background of fundamental reforms of its political and economic structures. It seems to be generally acknowledged that the fiscal decentralization process in Russia has been rapid, haphazard, and often non-transparent and that deficiencies in past as well as in the present system of intergovernmental finance have played a key role in the overall performance of the economy. The purpose of this brief paper is to provide an overview of the core aspects of the system of intergovernmental fiscal relations (Section II) and, in particular, to discuss the most pressing reform issues and needs that confront Russian policy makers (Section III) in this area. Acknowledging the overriding importance of sound incentive mechanisms and political accountability in a system of multi-tier government, the focus of the paper is on identifying areas where adverse incentive mechanisms are still in play, and must be addressed.¹

II. Core features of the present system of intergovernmental fiscal relations

We have found it useful to structure the discussion of the basic structural issues in accordance with five aspects which taken together define any system of intergovernmental finance: the institutional and legal structure; the system of expenditure assignment; the system of revenue assignment; intergovernmental transfers; and subnational borrowing provisions.

The legal and institutional structure:

The political and administrative organization of fiscal federalism in Russia is a unique blend of *de jure* federative organization and *de facto* elements of confederation and of a unitary state. Russia's 89

*The views expressed in this paper are those of the author(s) and do not necessarily represent those of the IMF or IMF policy.

¹ This paper reports in summary form the key but preliminary findings of a major ongoing research project carried out by the Fiscal Affairs Department of the Fund, on fiscal decentralization and economic performance in Russia, Ukraine, and Kazakhstan.

“subjects of the federation” have very different administrative and political status, largely reflecting differences in the relative degree of autonomy from the center and the ethnic mix of the population. The evolution of the legal and institutional framework since independence has reflected political compromises in the face of strong opposition from the regions, as evidenced from the proliferation of bilateral arrangements between the center and individual regions, rather than consistently applied rules and principles. In recent years, regions have also claimed greater *de facto* legal and regulatory authority, largely in the absence of effective federal instruments necessary to monitor and regulate regional fiscal behavior.

While the 1993 Constitution along with a panoply of supplementary laws and decrees, provide for constitutionally mandated interactions between different levels of government, the current legislation contains many inconsistent and conflicting provisions. In addition, rules and procedures to resolve competence issues, for example over shared responsibilities between central and regional governments and legislatures, are ambiguous and often contradict other legislation. Overlapping and poorly defined roles and responsibilities, asymmetric fiscal relations and unclear divisions of power between different levels of government have created confusion about the functions and modes of interaction of different parts of government, distorted incentives for prudent fiscal management at the subnational levels and encouraged creative accounting, including reliance on tax offsets and extrabudgetary funds. In addition, contradictions between the various legislation are often resolved in an ad hoc manner, with crucial provisions often decided in the annual budget laws, hence, imparting a measure of unpredictability and instability to the system of intergovernmental relations. Budgetary relations between regional and local governments as specified in current legislation also continue to suffer from ambiguities and confer considerable discretionary authority to regions over local governments, thereby, undermining local autonomy.²

Expenditure assignment

The absence of a formal assignment of expenditure responsibilities in the law has been problematic during most of the transition. Expenditure assignments until very recently were a continuation of the *de facto* assignments of the FSU, with ad hoc changes to this assignment implemented through the annual budget laws.³ In the early years of the transition, the attempt to shift expenditure responsibilities, in particular on capital and social outlays, onto subnational governments in the absence of an adequate assignment of revenues and inefficient negotiated tax sharing systems and grants imposed considerable pressures on subnational budgets. In many instances, this ad hoc shift in expenditures created disincentives for prudent fiscal management and resulted in the accumulation of payment arrears by subnational governments. In recent years, while some progress has been made in clarifying expenditure assignments, in a number of respects the assignment of expenditure responsibilities falls short of what is required of a clear, stable and transparent arrangement for effective decentralization.

² Activities of the local governments are regulated by a number of often inconsistent federal laws and laws on local government passed by the relevant regions.

³ The first complete formal assignment of expenditure responsibilities at the federal, regional and local levels of governments appears in the Budget Code, which was approved in 1998 (see Table 1).

While the actual assignment broadly follows international standards with national public goods and tasks assigned to the central level, and regional and local public goods assigned to the respective levels (Table 1), the lack of a transparent and consistent legal framework has importantly affected the workings of the system and the resultant ambiguities in assignment, have undermined accountability at different levels of government. The most important source of ambiguity continues to be in the assignment of the responsibility to regulate and issue norms. In particular, the role of line ministries and central and federal agencies has not been adequately clarified or adapted to meet the needs of a decentralized system of government. This has resulted in central agencies continuing to regulate and issue declarative norms that directly affect the expenditure positions of subnational governments. Unclear delineation of responsibilities over regulation, financing and implementation in the case of concurrent responsibilities, in particular for social expenditures, and the absence of effective institutions for coordination have resulted in the proliferation of unfunded mandates, expenditure requirements imposed on subnational governments in the absence of adequate federal funding.⁴ These unfunded mandates have served to limit the effective budgetary autonomy of subnational governments and added demands to their already strapped budgets. In addition, subnational governments have been slow to rid their budgets of private market interventions, with subsidies for housing and communal services, including public utilities, accounting for a large proportion of their expenditures. Budgetary control over expenditures has also been weakened by the increasing reliance on noncash budget execution. The problem of unclear expenditure assignments been especially acute at the regional-local level, with regional governments enjoying a high degree of discretion over assignments to their subordinate local governments.

Revenue assignment

The period up to 1994 was characterized by a revenue assignment system which was non-transparent and unpredictable owing to very frequent changes in basic sharing parameters, and assignments which were ad hoc and negotiated with individual regions. The “regulation” approach basically aimed at designing tax sharing arrangements such that individual regions had sufficient resources (in combination with their “own” revenues and transfers) to finance a set of defined “minimum” expenditures. The lack of clearly defined, stable and uniform revenue assignments between the center and subnational governments inherent in this approach weakened budgetary management at the subnational level and created perverse incentives for subnational governments to either hide locally mobilized revenue sources in extrabudgetary funds, or to simply reduce their efforts to mobilize revenues locally.⁵

⁴ Unfunded mandates arise from norms for social welfare benefits, the setting of wages and pensions, and norms and standards of service provision in many other areas.

⁵ See Lavrov, Litwack, and Sutherland (2000) for a discussion on extrabudgetary funds.

Table 1
Russia: *De Facto* Assignment of Expenditure Responsibilities in the Russian Federation in 1999

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

Environment	National environmental issues	Local environmental problems, (for example, the preservation of forests)	---
Public enterprises	Federal investment programs, subsidized credits, subsidies to particular sectors (mining, agriculture, tax benefits)	Subsidies to particular sectors (agriculture), investments, grants, tax benefits	Various explicit and implicit subsidies and benefits

SOURCE: Dabla-Norris, Martinez-Vazquez, and Norregaard (2000).

While the reform initiatives subsequent to 1994 have addressed some of these concerns, particularly at the central and regional level, the present system still suffers from a lack of effective tax autonomy at the subnational level. Revenues from taxes shared on a derivation basis, whose structures can only be changed at the central level, continue to account for the largest share of regional revenue receipts. Autonomy over taxes which are permanently assigned to subnational governments and whose yields are fully allocated to subnational governments is limited by federal restrictions over tax bases and rates.⁶ The minimal subnational autonomy to raise revenues and decide tax policies at the margin and the resultant mismatch between expenditure responsibilities and the real tax base, has important implications for accountability and responsibility at the subnational level. In addition, there are weaknesses in the choice of taxes that are shared between the center and subnational governments and how the shared tax revenues have been apportioned among subnational governments. Revenue sharing arrangements between regional and local governments continue to be based on the “regulatory” approach, with customized and yearly changing sharing rates and compensations through non-transparent transfers. This approach has created negative incentives for revenue mobilization as regional governments routinely claw back any additional revenues raised by local governments.

**Table 2: Revenue Sharing Arrangements, 1992-1998
(In percent of total)**

	1992		1993		1994		1995 Actual ⁷		1996		1997		1998	
	Fed	Loc	Fed	Loc	Fed	Loc	Fed	Loc	Fed	Loc	Fed	Loc	Fed	Loc
VAT	75	25	64	36	67	33	75	25	75	25	68	32	67	33
Profit tax	41	59	33	68	35	65	36	64	37	63	32	68	36	64
Personal income tax	0	100	0	100	1	99	9	91	9	91	2	98	0	100
Excise taxes	48	52	51	49	60	40	73	27	87	13	81	19	100	0
Property taxes	0	100	0	100	0	100	5	95	1	99	1	99	1	99

⁶ While subnational governments have discretion over the rate of the enterprise profits tax that applies to their shares, and have some control over the rates of the enterprise property tax and a housing maintenance tax, these rates are subject to a maximum set by the federal government.

⁷ Actual division of revenues from shared taxes, has differed from that dictated by law, in part because tax arrears have tended to accrue faster to the federal than to the regional level as regional governments have been more willing to accept monetary surrogates as payments, as well as due to the bilateral arrangements which allow individual regions to circumvent general regulations and entitle them to retain larger tax shares.

Natural resource taxes	0	100	29	71	15	85	24	76	25	75	20	80	12	88
Total revenue	60	38	46	54	48	52	48	52	50	50	47	53	43	57

Source: Dabla-Norris, Martinez-Vazquez, and Norregaard (2000)

The absence of a modern tax administration has also hampered both the day-to-day implementation of revenue assignments and adversely affected general government revenue collections. Despite the existence of a centralized national tax administration authority, a major difficulty in tax administration has been the inability of the federal tax collecting agency to exert effective control over the regional and local branches. The *de facto* dual subordination of tax officials has encouraged the widespread use of tax offsets and other monetary surrogates in subnational budgets, and weakened federal revenue collections.

Transfers

Historically, transfers were used to implement the “regulatory” approach towards revenue assignment and were gap-filling, and negotiated in nature. In the mid-1990s, a new system of formula-driven equalization transfers was introduced, known as the Fund for the Financial Support of Regions (FFSR), with two windows, one designed to equalize revenue availability across regions and the second to provide additional funding to regions with unmet expenditure needs. Total funding for this fund was determined in the annual federal budget and allocated separately between these two objectives, largely on the basis of past tax and expenditure performance of the region. This system had several significant limitations, associated both with the technical problem of appropriately measuring taxable capacity and expenditure needs as well as the problem of financing sufficient equalization transfers that resulted from a precipitous fall in general government revenues, in part as a result of the negative incentives to revenue mobilization discussed above. In addition, the actual determination of these transfers was subject to substantial political manipulation and pressure, with frequent changes in the formulas reducing revenue predictability for regional governments, particularly during the early years of transition.

Recently, a new equalization formula for the FFSR has been introduced, which combines both fiscal capacity and expenditure need equalization in a single step, with the funding for the equalization grant fixed in the annual budget as a percentage of all federal tax revenues (exclusive of import duties). While this represents a significant improvement over the previous system, the continued use of other ad hoc and non-transparent transfers, such as mutual settlements, which accounted for over 75 percent of all non-equalization transfers in 1998, have provided a disincentive for sound budgetary management at the subnational level.⁸ In addition, earmarked transfers to regions, which may be used for current or capital expenditure purposes, also contain a large element of negotiation and bargaining between the center and regional governments. At the regional-local level, transfers continue to be gap-filling and negotiated in nature, which provides local governments with a soft budget constraint and perverse incentives for revenue mobilization.

⁸ Mutual settlements, which consist largely of unbudgeted transfers to compensate regional governments for mandates or the delivery of federal programs, emergency transfers, as well as other negotiated and discretionary funds, are typically allocated during the process of budget execution.

Sub-national Borrowing

From the time of independence until very recently, subnational governments were granted the right to borrow with very few restrictions. In particular, no explicit limits were imposed and subnational governments were allowed to borrow for all purposes, including for the financing of current expenditures. However, as subnational governments had only limited access to private credit sources, most of the borrowing took the form of loans from the Ministry of Finance at the regional level and from regional finance departments at the local level and ad hoc adjustments in transfers, which provided subnational governments with a soft budget constraint. In recent years, concerns about the lack of responsible fiscal management at the subnational level and its impact on macroeconomic stability at the national level have prompted the introduction of limits and control regulation for subnational borrowing, and imposed limits on overall debt as well as limits of the budget deficits of regions as a shares of their budget revenues.

While the overall level of subnational borrowing remains low, there is an increasing trend towards greater subnational deficits, accumulation of debt, and loan guarantees, which resulted in the insolvency of a large number of regions in the aftermath of the August 1998 crises. Commercial bank debt has become the primary source of deficit finance, particularly since promissory notes (veksels) were disallowed since 1997. However, these transactions are often non-transparent and are subject to abuses.⁹ Another important threat to subnational budgetary discipline is the moral hazard or impression of a soft budget constraint created by the practice of granting loans by the central government that are eventually forgiven. In addition, official measures of regional budgetary deficits fail to reflect the reliance on expenditure sequestration, in particular for capital infrastructure, or the accumulation of sizeable budgetary payment arrears as important sources of deficit financing.

III. Elements of a Reform Agenda

A basic objective of any future reform initiatives with regard to the system of inter-governmental fiscal relations in Russia should be to eliminate or at the least alleviate the negative incentives inherent in the present systems. The reform agenda, however, should involve an explicit recognition of the substantial *de facto* authority that already exists at the subnational level in several areas, and should, therefore, attempt to balance the objectives of granting greater budgetary autonomy with that of improving capacities for regional and local budget management and control, while improving cooperation and coordination between the different levels of government.¹⁰ Key strategies and objectives to support this policy are summarized in what follows.¹¹

⁹ Despite the prohibition on veksels, subnational governments have continued to issue promissory notes or switched to alternative instruments, such as veksels issued by commercial entities including public companies under control of subnational governments.

¹⁰ The *Concept on Reform of Inter-Government Fiscal Relations in the Russian Federation in 1999-2000* outlines the authorities comprehensive agenda for reform of the fiscal decentralization system. While many of the proposals discussed in the *Concept* correspond closely to those suggested in this paper, in general, it proposes a strategy of reform that is stronger on

(continued...)

The legal and institutional structure

Incentives for sound fiscal management and local accountability could be substantially enhanced through a clear, consistent and stable legal and regulatory framework which assigns roles to the different levels of government in a much more transparent and predictable way. This would require preparation and implementation of a variety of new laws (such as Part II of the Tax Code) as well as amendments to existing legislation to eliminate inconsistencies between the main fiscal laws (Tax and Budget Codes and Law on Local Self-Governance, Law on Financial Foundations of Local Government), as well as improvements in the legislative framework for subnational borrowing. Developing supporting federal regulations for regional and local governments in the areas of budget classification, information disclosure, debt registration, etc. would allow for greater harmonization of standards across regions. Subnational governments also need to adopt regional and local laws and regulations that are consistent with federal laws (for instance, in the areas of tax sharing and transfers to municipalities), thereby, enhancing the accountability and transparency of the budget process. Laws and regulations should also clarify responsibilities within regional and local governments and legislatures for budget preparation, approval, implementation, and control.

Expenditure assignments

Increasing accountability and the overall efficiency of decentralized expenditures will require greater clarity in the assignment of expenditure responsibilities, in particular at the regional-local level, and by establishing primary responsibility or paramouncy in the case of concurrent responsibilities. Clarity would also be enhanced by explicitly assigning responsibility for regulation, financing, and implementation in cases where there is no exclusive assignment. This would also serve to control several sources of unfunded mandates. An important first step would be to achieve a greater coordination and harmonization of the rules in the budget codes or budget system laws and set out clear principles for regulatory powers, responsibility for financing, and responsibility for the delivery of the public services in the various sectoral laws (education, health, environment, etc.).

The system of expenditure assignments should also allow for greater subnational autonomy in setting service levels in accordance with local needs. However, since social assistance and welfare services have a distributional objective, regulatory and financing responsibilities should be assigned at the federal level and responsibilities for implementation assigned to the subnational level, with some matching fund

the reform of the system of equalization transfers and budgeting and fiscal management institutions, but weaker on expenditure and revenue assignment issues.

¹¹ Clearly, reforms in each of these areas will have to be prioritized in light of their feasibility over the short and medium term, including their political feasibility. The prioritization of this reform agenda will be discussed in detail in our paper on fiscal decentralization and economic performance in Russia, Ukraine, and Kazakhstan.

arrangements in order to provide subnational governments with proper incentives for expenditure management. Responsibilities over capital expenditures could also be clarified by making subnational governments responsible for the capital infrastructure needed to provide those services assigned to them.¹²

The scope of the subnational public sector should be rationalized by reducing untargeted subsidies for housing and public utilities, and reducing or eliminating the direct involvement of subnational governments in commercial activities. Federal policies to encourage regional reforms in this area should include some combination of legislation that imposes a hard budget constraint on subnational budgets, including imposing limits on borrowing conditional on fiscal behavior, and positive incentives such as aid conditional on demonstrable reform. Expenditure control at the subnational level would be also enhanced by improving institutions for budgetary management, including the adoption of a treasury function at the subnational level.

Revenue assignments

Elimination of the current perverse incentives for revenue mobilization at the subnational level would require a reform of the current system of revenue assignments in favor of a more stable and predictable framework. At the regional level, such reform would entail scaling back significantly the use of tax sharing arrangements, which reduce accountability and distort local voters and taxpayers perception of the fiscal costs of local services, and lead to excessive negotiations. Regional and local governments should be assigned at least one major source of revenue, for which they could determine the rate, in order to increase accountability and responsibility. The best option for developing subnational tax autonomy would be the introduction at the regional level of a personal income tax (on a residence basis) with a flat rate that piggybacks on a national progressive personal income tax, and second, the introduction at the local level of a real estate property tax.¹³ Given that the introduction of more significant autonomous revenue sources will not lead to revenue sufficiency of subnational governments in the near term, it is important to address remaining problems with tax sharing, including considering reassigning the VAT and enterprise profits tax at the federal level. In the absence of a permanent assignment of these taxes to the center, reforms should focus on implementing the apportionment formulas for the enterprise profits tax and using a more formula-based approach for sharing of the VAT.

At the local level, reforms will require abandoning the “regulatory” approach to revenue assignments in favor of a more stable, uniform and transparent system, with pre-defined sharing rates for local governments that are fixed for at least a three year period. Moreover, for reforms of revenue assignments to be effective, they must be accompanied by reforms in the transfer system. In particular, the use of formula-driven transfers to replace the current gap-filling negotiated transfers along with the

¹² This would require central authorities to provide prudent limits to subnational borrowing, monitor compliance, and facilitate the supply of long-term credit for well-planned and responsible capital expenditures by subnational governments.

¹³ In both cases, autonomy could be limited to choosing a flat rate up to a maximum rate legislated in the enabling legislation.

enforcement of hard budget constraints on subnational budgets would help to eliminate the disincentives to revenue mobilization.

The problems created by the *de facto* subordination of tax authorities to subnational governments has created conflicting incentives for tax collection. One way to address this problem is to strengthen and modernize the central tax administration, while paving the way for creation of tax administrations at the subnational level charged with the enforcement and collection of regional and local taxes. An effective way to proceed would be to adopt pilot programs with separate tax administrations in some regions and large cities with taxes well suited for local enforcement, such as the real estate property taxes. In the longer term, the development of a tax administration capacity at the subnational level should also take into account the significant institutional limitations of subnational governments.¹⁴

Grants

While considerable progress has been made over the last year in improving the formula of the equalization fund, reform efforts should continue to aim at developing an efficient and formula based equalization grant based on accurate measures of tax capacity and expenditure needs. Stability in the funding of equalization transfers could be enhanced by shifting to a rule that fixes the level of funding as a percent of central government revenues for a period of three years. In addition, there is an urgent need to get rid of the current ad-hoc and non-transparent system of mutual settlements, forgiven loans and special subventions. These should be replaced by a system of transfers that have explicit objectives, are implemented as categorical or conditional grants, are explicitly budgeted ex-ante and allocated according to objective and transparent criteria.

At the regional-local level, there is an urgent need to reform the system of gap-filling transfers by introducing norm-based formulae based on tax capacity and expenditure needs rather than past economic performance. While some regions have already initiated such reforms, they need to be undertaken in a wider framework of reform of the system of intergovernmental relations, including revenue and expenditure assignments.

Borrowing

There are several basic approaches for bringing discipline and responsibility to subnational government borrowing, from reliance on market discipline to a rules based approach to direct central government controls. Given that Russian financial markets and institutions are not sufficiently developed to exert effective discipline on subnational borrowing, the best approach would be to rely on a combination of central legislation and regulation with appropriate central monitoring and enforcement. Regional and local borrowing should be limited in accordance with clear and transparent principles that take into account the debt servicing capacity of subnational governments. While limits to the overall level of debt of regional and local governments imposed by the Budget Code are in line with international practices,

¹⁴ In light of these limitations, in some cases the administration and enforcement of local taxes should be kept at the regional or central level. For instance, piggyback taxes, such as a regional PIT could continue to be administered by the central tax administration.

allowing subnational governments to borrow to finance all expenditures, in particular current expenditures, is poor financial management.

Improvements in monitoring and enforcement of the legislated borrowing limits also require immediate attention. For instance, federal regulations requiring the centralized registration of all subnational borrowing would make it easier to monitor debt levels. In addition, assessing the present level of subnational debt is complicated by the widespread use of nonmonetary sources of borrowing, loan guarantees and budget arrears. Efforts should be made to phase out noncash forms of budget execution and existing arrears restructured in order to improve debt management at the subnational level.