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Regional Economic Policy, Budgetary Federalism, And Interbudgetary Relations

The federal government needs to have a regional economic policy—i.e., a policy for the state regulation of regional development. A **state regional economic policy (GREP)** should pursue two objectives:

promoting economic development in the regions, and hence in Russia as a whole; and

strengthening the structure of the state through the equalization of social and economic conditions in the regions, thereby ensuring the homogeneity of the country.

These objectives are mutually contradictory. To a certain extent, economic development negates equalization, since development means first and foremost the development of wealthy regions as the locomotives of overall economic growth, and regional differentiation is bound to increase in the course of such development. Regional differentiation is already on the increase: From 1992 to 1998, the difference between the maximum and minimum regional values for per capita budget expenditures doubled (from 1:12 to 1:22), and the analogous difference in terms of per capita gross regional product rose by a third (from 31:1 to 41:1). This is associated with the problem of so-called depressed regions.

Interregional equalization evens out differentiation (characteristically, budgetary differentiation, where equalization mechanisms operate, is less marked than differentiation with regard to economic development as a whole) and thus inhibits economic development. The process of strengthening the state requires resource redistribution on a large scale, including redistribution within the framework of interregional equalization. This is the basic contradiction confronting Russia's national development, and a very great deal will depend on its political resolution. Curtailing the scope of redistribution would be analogous to broadening the territories' revenue powers, something their governors have been urging. These governors have also been demanding a redistribution of property. An increase in the scale of redistribution would limit the scope of the territories' revenue powers. One political solution would be to strengthen the positions, not of individual governors, but of the Federation Council as a whole, which could be given additional powers and oversight authority with respect to a number of important fiscal measures. This could apply first and foremost to the problem of expenditure powers and the enactment of unfunded laws, a problem that has hurt territorial budgets.

A similar problem arising from the development vs. equalization dilemma exists at the subfederal level: In virtually all of the federation's constituent members, two or three municipalities account for the bulk of the budget's revenues, and the gap between these municipalities and the rest is widening.

Apart from all else, this tendency complicates the establishment of stable normatives for the territories' own revenues (something that many constituent members of the Federation and municipalities are demanding), since it impedes the creation of redistributive budgetary funds, which would increase differentiation still more.

Since regional differentiation will become more pronounced as we make the transition to economic growth, the only way to even out differences in people's standards of living that does not stifle economic development is to ensure interregional labor mobility, allowing labor to move to areas where it can be used more efficiently. For this reason, the long-term strategy of the federal center should consist not in promoting budgetary equalization through tax rates and transfers, but in fostering conditions for labor force mobility (for example, by reforming labor relations, creating a nationwide housing market, and lifting such administrative barriers as residence permits and others).

In the short term, however, we would recommend equalization (interregional redistribution) on an even somewhat greater scale than is currently the case, although efforts must be made to ensure that this equalization is objective and transparent at the same time. Then, step by step, this equalization could be reduced as the legitimacy of the state is genuinely strengthened and revenue and expenditure powers are distributed and codified in a more explicit fashion.

Basic proposals:

1. **Expenditure Powers**.

1.1. It is essential to conduct a thorough inventory of the existing expenditure powers of the various levels of government (especially in areas where "joint jurisdiction" is mandated), and subsequently to explicitly regulate these powers through legislation, in order to make it clear, with none of the ambiguities that currently exist (for example, where education is concerned), exactly who is responsible for what and who is to pay for what. Steps should be taken to sharply reduce the number of areas of joint jurisdiction. And in those that remain, we must determine who bears primary responsibility and who is merely a "co-executor." In the process, the basic federal responsibility must be the performance of obligations pertaining to a large number of territories, in particular the fostering of overall economic stability and social justice (since this calls for interregional redistribution). Appropriate amendments to the Budget Code should be drawn up in order to implement these arrangements.

1.2. It is essential to begin a process of repealing (on the basis of the aforesaid thorough inventory) unfunded federal laws and other normative acts and to enact legislation prohibiting the adoption of such laws and acts in the future. A trilateral commission should be established for this purpose (consisting of the Government, the State Duma and the Federation Council). In order to give the Federation Council a political interest in this process (see the introductory remarks), its role should be further enhanced—for example, by initiating a draft law establishing that overriding a Federation Council veto on laws that increase the regions' expenditures without providing corresponding financial support will require a four-fifths vote in the State Duma, as opposed to the two-thirds vote that is needed today.

1.3. Pending the achievement of a positive solution with respect to point 1.2, the Regional Financial Support Fund should be divided into a budgetary support equalization fund per se and a fund that would be used to finance powers transferred from the federal level to the regional level. The problem is that, from a functional standpoint, these are completely different tasks: The first has to do with reckoning objective revenue capabilities and expenditure obligations, while the second deals only with expenditure obligations that are transferred for one reason or another. Consequently, the budgetary support equalization fund could be fully balanced on the basis of due regard for the various territories' taxation capabilities and budgetary requirement ratios for their populations, while the fund for financing transferred powers could be balanced only as a result of the rescinding of financially insolvent state obligations.

Before unfunded expenditure powers are rescinded, they should be included, at least in part, in federal budget expenditures (within the framework of the aforesaid fund for financing transferred powers), and the Duma should be asked to address the problem of finding the additional revenues needed to fund them. In the process, it would be advisable to mark out a zone of federal social responsibility; for example, child benefits should be made a federal responsibility—given a commensurate increase in the federal share of tax distributions.

1.4. Public relations with the regions should be devoid of any diktat or pressure (as experience shows, threats are useless); rather, they should be based on cooperation and a working partnership. To this end, it would be advisable to set up joint working groups and expert councils, as well as structures through which to hold constant, on-going consultations—such as a budget council made up of representatives of the Ministry of Finance and the territorial financial authorities, a standing interregional tax conference, and a joint commission on budgetary reform.

Regions often fail to carry out necessary reforms not because they are unwilling to do so, but because they don't know how. Consequently, full-scale federal technical assistance for regional reforms and regional development must be made available. In particular, it is essential to draw up a standardized set of normative documents pertaining to financial and economic policy in the regions. The emphasis (especially the public emphasis) in dealings with international financial institutions should be shifted to regional problems. Stepped-up lending should be made available for restructuring regional finances, and negotiations should be initiated on securing other loans that are both regional and investment-oriented in nature.

2. **Revenue Powers**.

2.1. As matters stand, the organization of the budgetary system is inefficient, with a serious revenue and expenditure imbalance among its various tiers. The federal budget and the municipal budgets are underfunded, while the budgets of the federation's constituent members are overfunded (if we set aside unfunded transferred powers). For this reason, it is necessary above all to increase the share of the municipal tier in budgetary system revenues and to make that share consistent with its share in budgetary system expenditures. This will promote the achievement of a more effective balance of powers. In principle, moreover, expenditures at the local level are more targeted and more transparent, and there are fewer inefficient expenditures such as price subsidies and subsidies to enterprises, which are concentrated primarily in the budgets of the federation's constituent members. Steps should also be taken to increase the federal budget's share of budgetary system revenues given the previously noted growth in interbudgetary redistribution using these resources.

2.2. Efforts must be made to solve the problem of tax payments made by national Russian companies (for example, Gazprom, the Unified Energy System Russian Joint-Stock Company, Lukoil, the Moscow Interbank Currency Exchange, Sberbank, Rosvooruzheniye [the Russian Arms State Company], Rosneft [the Russian Petroleum Company] and others), which pay taxes on the basis of their place of registration (i.e., to Moscow). A variety of approaches are possible here:

a) the arrangement proposed in the Tax Code, whereby taxes due from the various territorial divisions of an interregional company would be paid in proportion to the value of these divisions' assets and their numbers of employees;

b) a federal tax district could be created and the aforesaid national Russian companies could be registered in it. In this case, not just the federal share, but also the regional and municipal shares of these taxpayers' taxes would be paid to the federal budget. In order to give the regions an interest in this arrangement, it could be proposed that these funds be earmarked specifically for the Regional Financial Support Fund (the FFPR);

c) the budget law could stipulate in a separate provision that tax receipts from these companies would be paid to the federal budget and would be used to augment the FFPR. In general, this would be a good arrangement, since the distribution of the FFPR is more transparent, manageable and targeted than is the distribution of taxes on the basis of differentiated rates; in other words, budget efficiency would be enhanced and, at the same time, political influence over the regions would be strengthened. In this event, the FFPR would be formed from a set share (10% or 11%) of all federal budget tax revenues, plus the tax receipts from the national Russian companies that were previously earmarked for the regions.

2.3. The basic thrust of efforts to optimize the distribution of taxation powers should be to replace, insofar as possible, the regulatory taxes that are currently divided among the various tiers of the budgetary system with each tier's own taxes.

In principle, value-added tax should be a federal tax (for all practical purposes, VAT is usually paid in one region but claimed as an offset in another). If such a solution were to prove politically difficult, a palliative measure could take the form of distributing a regional portion of VAT among the regions in proportion to their populations or in proportion to an objectivized per capita budgetary requirement. Under this arrangement, the sales tax should be abolished.

The tax on natural resources should be a federal tax, since it realizes the principle of overall state ownership of natural resources and natural resource rent. At the same time, territories in which subsurface resources are exploited could receive compensation from the federal budget for restoration of the natural environment.

The income tax should be distributed between the federation and its constituent members. It would be even better to have two separate income taxes—a federal one, preferably with a fixed rate, and a regional one. The latter tax should be paid not through the taxpayer's place of employment, as is currently the case with the income tax, but to the governmental authority having jurisdiction over the taxpayer's place of residence, since it is at a person's place of residence that the major social services are provided.

A version of the two-tax option—one federal and one regional—could also be proposed for the profit tax.

The real estate tax should be local and should serve as the foundation of municipal finances.

On the whole, this would ease the vertical imbalance of the budgetary system.

3. Tax Administration.

3.1. At the present time, the tax authorities are federal in name only; in actual practice, they are heavily dependent on the governors, both financially and administratively. Hence the far higher rate of collection of taxes payable to regional budgets than of taxes paid to the federal budget. It will be difficult to alter this situation in a smooth manner. One possible solution would be to create a new federal tax service that would be charged with collecting only federal taxes and assessments, leaving the current tax service to operate as a regional one.

3.2. Another option would entail assigning not taxpayers, but tax authorities to federal and regional categories where regulatory taxes are concerned.

4. Providing Financial Assistance to Lower-Tier Budgets.

4.1. Finally, it is essential to clarify exactly who is in fact a donor and who is a recipient. To do so, we need to conduct an inventory of all federal expenditures by territories (to include the numerous investment programs, the upkeep and operation of federal institutions at the local level, the budgetary network whose funding is assigned to the federal authorities, and other expenditures), and to determine the aggregate balance of the regions' financial settlements with the federal budget (and not just of their receipts from the Regional Financial Support Fund, as is currently the case). An analysis conducted by the Institute of Transition-Period Economic Problems using this methodology found that donor regions (notwithstanding the arbitrary character of the use of this term in general) numbered not 10, but nearly 30.

4.2. Providing support to the budgets of depressed regions is a separate problem. These regions should be divided into two groups:

a) regions in which a heavy dependence on federal assistance stems from poor financial management, in which case reforms, fiscal adjustment and the introduction of best practices are called for (things that may have to be initiated through the introduction of federal administration); and

b) regions that will always be depressed by virtue of objective circumstances; in the case of these regions, the federal center will have to assume direct responsibility for the performance of state obligations, with the possible introduction of the special status of “territories with limited financial autonomy.”

4.3. In conjunction with a mechanism of vertical equalization (i.e., from the federal budget to recipient regions), it would make sense to initiate the creation of a mechanism of horizontal equalization in which the wealthy regions would make transfers to the budgets of poor regions in accordance with a prescribed methodology.

4.4. Further steps must be taken to ensure objectivity and transparency in the distribution of the Regional Financial Support Fund by:

devising an indicator for a given territory’s revenue potential;

defining more precisely indicators for objective per capita budgetary requirements;

stimulating the taxing efforts of the territories, to which end relative per capita equalization, not total equalization, should be promoted.

4.5. This same approach should be taken to the formulation of proposals regarding a mechanism for internal regional (i.e., intermunicipal) transfers.

4.6. Previous experience forces us to take a cautious approach to the idea of transfer conditionality: Attempts to make financial support contingent on a large number of various conditions are not successful, as a rule. It is more important to enlist the regions in efforts to improve their budgetary systems by providing technical assistance to them and by helping them obtain financial support, including financial support from international financial institutions.