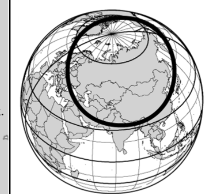
Russian Federation (Overview)

Capital: Moscow
Population: 144 Million
(2002 est.)



Boundaries and place names are representative only and do not imply any official endorsement.

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Sources: ESRI Ltd.; CIA World Factbook; Times Atlas of the World

The Russian Federation

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Russia is a federative state with a republican form of government. The chief executive is the president, who is elected by direct votes of the people for a term of four years. The same person cannot hold the office of president for more than two successive terms.

The Russian Parliament comprises two chambers: the State Duma and the Council of the Federation. The State Duma has 450 deputies – members of the political parties that successfully passed the 7 percent barrier at elections. Elections to the Duma are based on universal, secret, equal, and direct suffrage for a term of four years. The Federation Council comprises two representatives from each region (subject) of the Russian Federation: one from the legislative and one from the executive branch of power. Depending on the region of the Federation, members of the Federation Council are appointed by either the head of the regional administration or the legislative assembly.

Russia is the world's largest federation, consisting of eighty-six (as of 1 January 2007) regions (see Table 1). The parade of sovereignties in the early 1990s (in the wake of the breakdown of the USSR) reflected the ethnic republics' quest for political and economic independence, which led the existing administrative-territorial units to split up and form the new constituent units of the Russian Federation.

Disparities in climate, population, and development between regions hinder the development of symmetric federal-regional relations, thus making a case for consolidating units of the Federation through mergers. The first practical steps towards consolidation were made in 2004, following an official decision on the merger (effective from 1 December 2005) of Perm Region and Komi-Perm Autonomous District. In the pipeline are Krasnoyarsk Krai with Taimyr and Evenk Autonomous Okrugs, and Kamchatka Region with Koryak Autonomous Okrug. Further

Table 1
Basic political and geographic indicators

Official name	Russian Federation (Russia)
Population	143,474,200
Area	17,075,400 square kilometres
GDP per capita in US$	(2004): 4,214
Constitution	1993, democracy, federation, republic
Levels of government	Federal, regional, and local. Local governments can have one or two tiers; some regions (autonomous *okrugs*) have two tiers of state government
Constitutional status of local government	Separate tier, not part of state government
Official languages	The official language of the Federation is Russian. Ethnic republics have several official languages: Russian plus ethnic language/s. Some ethnic localities within constituent units (regions) also use two official languages.
Number and types of constituent units	There are 21 republics (ethnic autonomies), 48 oblasts, 7 krais, 2 federal cities, 1 autonomous oblast, 7 autonomous okrugs (autonomous districts). The RF Constitution grants equal rights to all constituent units of the federation, disregarding their type.

mergers could hardly be on a mass scale because the merger of a relatively wealthy region with a poorer one would lower the per capita budget revenue of the former, so it would not be easy to sell this idea to residents of wealthier regions.

THE STRUCTURE OF GOVERNMENT AND DIVISION OF FISCAL POWERS

The Russian Constitution establishes two levels of government: state government and local self-government. The state level subdivides into federal and regional, with local self-government, according to the 1993 Constitution, falling outside the system of state power.

The procedure for establishment of regional bodies of state governments is set by federal law according to general principles of the organization of legislative (representative) and executive state government bodies. This law establishes, inter alia, a list of powers of state government bodies and the procedure for conferring powers on the chief executive of a region, whose candidacy is nominated by the president of the Russian Federation and approved by the regional legislative assembly.

Federal law also establishes general principles of organization of self-governance in the Russian Federation. This law was passed in 2003, but it comes into effect in stages and is not expected to become fully effective until 2009.

The Russian fiscal system features three to four tiers, depending on the type of jurisdiction. For state government, it is the federation and region. For local government, it is the city, or municipal district (*raion*), and settlements (*poselenniye*) in a municipal district.

Formally, federal, regional, and local levels of government have designated revenue sources and spending obligations, and each level drafts and approves its own budget. One might see this as evidence of the fiscal autonomy of subnational and local governments. However, this would be incorrect as the upper levels of government continue to rule both the revenue and expenditure arrangements of the lower level governments. Subnational governments do not have transparent mechanisms to determine the total amount of revenues that will be available to them in a forthcoming year, nor do they have the authority to levy taxes other than those established by the Tax Code of the Russian Federation and other federal laws.[1]

The Assignment of Spending and Regulatory Responsibilities

Federal laws govern the expenditure obligations of the subnational governments, although regions and localities (except for the recipients of the equalization transfers) may choose to expand the list of spending obligations established for them by the federal government, if they have their own resources to fulfill them.

The 2000–04 reform of federative relations and local government targeted comprehensive demarcation of expenditure obligations and revenue sources across all levels of government in the Russian Federation, but the result was somewhat disputable. Federal legislation still sets basic requirements to, or details of, expenditure obligations, and each level of government is responsible for the provision of public goods and public services in conformity with the assignment of spending responsibilities. From that perspective, there are no explicitly federal or explicitly regional functions in Russia: decentralization is limited to deciding which level of government would finance the delivery of standard public goods and/or services, but the standards are established by the central government.

In the course of the 2000–04 reform, three categories of government functions were identified: (1) functions that subnational and local

Table 2
Legislative responsibility and actual provision of services by different orders of government

Legislative responsibility	*Public service*	*Actual allocation of function*
Federal	Defence	Federal
Federal	Law and order	Federal
Federal	Environment security	Federal and provincial
Federal	Higher education	Federal and provincial
Federal and provincial	Secondary education	Local
Federal and provincial	Health	Federal, provincial, and local
Federal and provincial	Welfare	Provincial
Federal	Tax collection	Federal
Federal	Civilian registry	Local
Federal, provincial, and local	Culture	Federal, provincial, and local
Federal, provincial, and local	Housing services	Local

governments perform and finance from their own resources; (2) delegated functions (i.e., those that governments of lower levels perform and governments of upper levels finance through earmarked transfers); and (3) functions that fall into the category of exclusively federal responsibilities (e.g., national defence [see Table 2]).

In 2005, a new assignment of expenditure responsibilities was enacted, although, for several reasons, this was unsuccessful. One reason for its lack of success is that, due to a dramatic reduction in the political weight of regional governors, the power of regional governments has substantially shrunk. Then, some actual expenditure needs of the regions were overlooked, while a significant number of federal functions performed by the regions remained unfunded (unfunded mandates). These all led to further revisions of the assignment of spending responsibilities in 2005 and 2006.

It is pertinent to note that, given current budget reporting requirements in Russia, a number of federal or regional spending obligations transferred to lower levels of government together with funds are recorded in relevant sector items as expenditures of lower-level governments, while the government that provided the funding reports them as intergovernmental transfers (see Table 3). This is the case, for instance, with regard to social spending obligations such as education (recently

Table 3
Direct expenditures by function and level of government (2006)

Function	*Federal (%)*	*State or provincial (%)*	*Local (%)*	*All (%)*
Defence	100	0	0	100
Debt servicing	85	13	2	100
General administration	58	22	20	100
Law and order	77	20	3	100
Economic services	36	56	8	100
Social services	46	31	23	100
health	13	69	18	100
education	22	26	52	100
Subsidies				0
Total	54	29	17	100
Local public services*	13	45	42	100

* Local public services include: primary and preschool education, secondary education, public health, hospitals, urban highways, urban transportation, drinking water and sewerage, waste collection, electric power supply, fire protection, public order and safety, police

shifted from the regional to local level of government together with the targeted transfers) and social safety net benefits (transferred from the federal to regional level and then, in part, from the regional to local level). Health care does not include spending on the compulsory medical insurance fund, which stays out of the general budget and has revenues and expenditures that are less transparent.

Monitoring of budget execution is quite thorough. Local governments furnish their financial statements of budget execution to the regions, which, in turn, submit their own plus municipal statements to the federal Ministry of Finance. The Russian Accounting Chamber (the federal financial auditing body) performs comprehensive audits of regional governments that are recipients of federal grants (75 percent of all regions) on top of regular audits of targeted-use grants transferred to regional governments for the implementation of federal mandates. Regions employ the same scheme to monitor local budgets. Monitoring is focused, inter alia, on the match between reported expenditures and the expenditure responsibilities of subnational governments established by federal law.

The Subsidiarity Principle and Causes of Conflicts in Intergovernmental Fiscal Relations

The subsidiarity principle is adhered to only for housing and communal services, education, maintenance of cultural institutions, and health care. Some traditionally local services, such as public transport, roads, fire prevention, and public safety, are funded and provided by regional rather than local governments.

Regional bodies of the federal government also perform a number of local functions. These include law and order and tax collection. According to the Russian Constitution, local self-governments are not authorized to undertake legislative and/or enforcement measures; these functions are assigned to the state. However, the Constitution obliges local self-governments to safeguard public order. The City of Moscow, certain districts of the City of St Petersburg, and the cities of Perm and Saratov did create municipal police units; however, these in fact became part of the federal police, and they report to the Federal Ministry of the Interior rather than to local mayors.

The current system – wherein the assignment of spending responsibilities and the monitoring of budget execution are controlled by the federal government, while spending obligations and budget execution per se are controlled by the subnational governments – often produces clashes of interests. For instance, in 2005 the law on monetization of social benefits was enacted to substitute federally guaranteed in-kind social benefits with cash payments. The provision of these benefits used to be an unfunded mandate imposed on regional governments by federal regulations. Unfortunately, the Ministry of Finance underestimated the amount of social expenditure obligations of the regional governments when allocating monetization grants to the regions. This led to the inability of the regions to implement the new law. In January 2005, pensioners in a number of Russian regions, driven by the loss of their right to use public transportation free of charge, and not having been fully compensated for this with a cash subsidy, picketed highways. The federal government then had to take advantage of the record-breaking surplus of the federal budget in 2005 to substantially increase the size of the compensation transfers to the regions.

Redistribution of state assets between regional and local governments illustrates another type of intergovernmental conflict. Federal regulations prohibit subnational and local governments from holding assets that are not directly involved in delivering the public services assigned to them. Federal law mandates that all such property should be assigned to the government that is responsible for delivering the service; however, it says nothing about compensation or what should be done with the property that is not involved in delivering public services but, rather, is a source of local government revenues. Hence, there are property shuffles between regions and municipalities and desperate activities on the part of local governments to protect property at all costs. Some local authorities have found a solution in selling off (privatizing through shell companies) municipal buildings occupied by regional administrations. Courts are snowed under with claims brought by regions against municipalities and vice versa.

Intergovernmental conflicts resulted in calls to expand the transition period (established for the full implementation of the law on self-governance throughout Russia) and to postpone the implementation of a number of provisions until 2009.

Common Values: Emphasis on Social Services, Military Spending, and Horizontal Equity

Judging by the allocation of consolidated government funding across functions, the most important public goods in Russia are education, pensions, national defence, the social safety net, and law and order. These expenditures account for almost 60 percent of total spending of the fiscal system (including all levels of government but excluding special federal social security funds – the Medical Fund, Pension Fund, and Social Insurance Fund).

Federal transfers to subnational governments constitute about 15 percent of total federal expenditures, making it the third largest expenditure item of the federal government. The largest spending item of the federal government is transfers to the Pension Fund (18.6 percent of total federal expenditures), followed by national defence outlays (16 percent). The budget of the Pensions Fund in FY2005 was $47.5 million, of which $18.1 million consisted of transfers from the federal budget. As for subnational governments, their largest spending category is education, followed by health care and housing and grants for communal services. The purpose of the latter is to compensate providers of housing and utility services for their losses from state-regulated tariffs.

To the common people in Russia, the main function of government at any level is social protection of vulnerable groups, including old-age pensioners, families with children, war veterans, disabled persons, and many others (there are more than 150 categories overall). A special category is the working poor – schoolteachers and doctors in the public sector, whose wages have been the lowest in the country for years. To correct this, the federal government has recently launched "national projects" for education and health care that target increased wages in these sectors and the purchase of modern equipment. However, these projects are not contemplating structural reforms and serve mainly as an additional cash channel.

Channels of Federal Influence on Subnational Policies and Vice Versa

Although the federal government has not officially stated the goals and objectives of intergovernmental fiscal relations, it does have a number of tools that allow it to influence regional fiscal policies either directly or indirectly. The tools for exerting financial influence on the regions include:

1 Earmarked transfers. This is a tool that directly influences regional budget policies (funded mandates). Spending these grants is subject to strict control by the federal authorities, and the share of these grants in total subnational revenues is rapidly growing.
2 Budget loans. Because the Russian banking system is underdeveloped, the federal government budget is often the only source of short-term lending available to subnational governments for covering cash shortages. Until GY2005 the budget loans were interest free. The federal budget provides these loans selectively, although selection criteria are not transparent.
3 Non-formula-based transfers. All regions, including the relatively wealthy Moscow, Tatarstan, and Bashkortostan, receive transfers other than equalization grants. Most of these are capital transfers that are invested in public improvements (e.g., subways, highways, and restoration of historic sites).
4 Timing of transfers. No schedule is fixed for the disbursement of transfers to regions; therefore, the federal government can choose the timing, warranting absolute loyalty on the part of heavily subsidized regions.

Thus, the federal government dictates budget policies to the regional governments, not the other way around. The Federation Council is not instrumental in protecting regional interests: it approves virtually all federal bills that impose unfunded mandates on regional governments and has approved the abolition of a number of regional and local taxes. Furthermore, the council approved the president's initiative to change the council nomination procedure. Formerly, each region of the Federation was represented in the Federation Council by the governor and the speaker of the legislative assembly. Under the new procedure, each region of the Federation is still represented by two council members, but these are nominated either by the governor or the legislative assembly of the respective region and approved by the Federation Council. This new procedure has substantially weakened the council's political influence.

The Legal Status of Local Governments and the Provision of Local Services

According to the Russian Constitution, local self-governance should be implemented throughout Russia. Until recently, however, many localities had no elected self-government, and they were administered through local offices of the regional government.[2]

The new federal law (2003) introduced two levels of local self-governance, including settlements (*poselennyie*), either urban or rural, and municipal districts/urban districts (i.e., cities that combine the functions of a settlement and a municipal district). Furthermore, the entire territory of Russia was divided into municipal districts and urban districts. Territories with low population density may not have a settlement level of government. All these entities are called municipalities, and the total number of municipalities in Russia exceeds 24,000. Federal cities (i.e., Moscow and St Petersburg) have the right to issue their own regulations regarding the organization of local self-governance within their boundaries.

The responsibilities of regional authorities with respect to the organization of local self-governance are limited to procedural matters, such as the establishment of boundaries and the status of municipalities, scheduling first elections, and so on. Federal law strictly defines the scope of local self-governance, although regional governments may delegate some regional functions to local governments, together with the resources to perform them. This does not work in reverse (i.e., local governments do not delegate local functions to regional governments), except when local governments become insolvent. Bilateral agreements on the relocation of functions (together with their associated resources) are possible only between municipal districts and settlements within districts.

Special Features of Providing Local Services in Rural Areas

In Soviet times, collective farms used to be major providers of services in rural areas. Today, most of the former collective farms are joint-stock companies, with 100 percent of the stock held by regional governments, and these companies continue to support villagers in one form or another. The forms of support include providing fodder, seeds, and timber for heating purposes; plowing land in village smallholdings; and so on. In monetary terms, the total cost of services provided by such a farm to local residents may exceed the cost of public services provided to them by the local government. This, of course, does not favour business development. Reports do not capture the actual losses of these farms from the performance of social safety net functions, but it is commonly recognized that their economic inefficiency correlates with the amount of their welfare activities. These successors to collective farms and private smallholdings exist as a symbiosis, and a considerable portion of the subsidies and benefits these farms receive from the government ends up supporting the private smallholdings of their labourers. The low labour capacity of these farms is also attributed, at least partially, to the fact that they continue to provide employment to local residents as a form of welfare support.

Collective farms used to hold most of the communal utilities in rural areas, such as roads and heating systems, and these facilities serviced both the farms and the households. The current ownership of communal utilities in rural areas is mixed: some of them remain in the ownership of former collective farms; others were taken over by local self-governments. Utilities are often subsidized through federal or regional targeted programs. For instance, improvement of local roads is financed through the federal program entitled Modernization of the Transport System. In this program, the federal government transfers funds to regional governments in the form of earmarked capital transfers, and regional governments upgrade the internal roads of former collective farms to bring them into the network of public roads.

Barriers to Trade and Factor Mobility

The Constitution of the Russian Federation guarantees a common economic space; free movement of goods, services, and capital; support for competition; and freedom of entrepreneurship. Nevertheless, barriers to trade between regions do exist and take different forms, such as inspection of goods en route to prevent export of subsidized agricultural products from the region, various charges for entry to a regional/local market, and establishment of onerous sanitary requirements. In the 1990s, regional administrations even levied taxes on imports (primarily, imports of alcohol), but this practice was banned by the federal government.

Since regional authorities have virtually no revenue autonomy, they often set trade barriers for dual purposes: for fundraising and for protecting local producers. In addition, regional authorities use administrative levers to drive out competitors. All this leads to serious market distortions. According to the estimate of the Russian Federation Ministry of Agriculture, removal of barriers in interregional grain trade would have reduced domestic grain prices by 25 percent.

Big cities, such as Moscow and St Petersburg, maintain a system of obligatory residence authorization as a barrier to labour movement in order to protect their citizenry from competition in the labour market and their budgets from additional social expenditures.

ECONOMIC AND FISCAL POLICY COORDINATION

The legislative and executive branches of the federal government design and monitor Russian economic and fiscal policies, including regional ones. The federal government monitors regional development by means of statistical observations and departmental reporting, where regional line ministries report to their federal counterpart ministries. The governors report on the social and economic achievements of their regions at the sittings of the federal Cabinet of Ministers.

Formally, governors have to draft short-, medium-, and long-term programs for the social and economic development of their regions. Unfortunately, a typical regional program establishes no objectives, time frame, or indicators, so it looks more like a political agenda than an action plan.

The revenue autonomy of regional governments is negligible, and their influence on regional fiscal policy is limited to varying the rates of certain taxes (within the limits established by the federal government) and introducing tax exemptions from regional and local taxes. When both regional development and fiscal equalization are regulated by the federal government, the issue of interregional economic and fiscal cooperation is not on the top of the list.

Monetary Policy

The Central Bank of the Russian Federation is responsible for the design and implementation of monetary policy. The bank reports to the State Duma, which appoints the chair of the bank nominated by the president, and members of the board nominated by the chair of the bank. The bank's performance is monitored by the National Banking Council, whose members represent the Federation Council, State Duma, President's Office, Cabinet of Ministers, Central Bank, and regional governments.

Soft Budget Constraints and Fiscal Discipline

Until 2000, soft budget constraints created a serious problem. But since then, federal legislation has established strict limits on regional/local debt and the level of current budget deficits, and subnational over-borrowing has ceased to threaten the stability of the budget system. According to Russian Federation Ministry of Finance surveys, the most common violation of financial discipline on the part of regional finance departments is the presence of overdue liabilities. In 2006, thirteen out of eighty-six regions reported they had overdue liabilities.

The other common breach of financial discipline is excessive remuneration of regional officials. In many regions that are recipients of federal equalization transfers, regional officials get higher wages than do federal officials of the same rank, which is against the federal regulations.

Assignment of Revenue-Raising Powers

Sources of government revenues in Russia are taxes, non-tax collections, and intergovernmental transfers. Earnings from the business activities of subnational governments often accrue to extra-budgetary funds that are controlled by the government but are beyond public control. Regional taxes account for roughly 3 percent of the total revenues of the consolidated budget of the Russian Federation, and the share of local taxes is less than 1 percent. On average, regional and local taxes account for 9 percent to 10 percent of total subnational government revenues. The majority of regional revenues are comprised of federal shared taxes.

Taxpayers pay taxes to governments at all levels through the offices of the Federal Treasury, and the Federal Tax Service administers the collection of all taxes, federal and subnational alike (see Table 4). Neither regions nor municipalities have the authority to collect or monitor the collection of subnational taxes. This sometimes results in under-collection of subnational taxes because the Federal Tax Service, as a federal body, is interested primarily in collecting the taxes that accrue to the federal budget. For the same reason, the collection rate of shared taxes that partly accrue to regional budgets tends to be higher than that of taxes that accrue 100 percent to subnational budgets. Since the majority of subnational governments in Russia levy regional and local taxes at the maximum rates allowed by federal laws, subnational revenue autonomy is limited essentially to the use of regional/municipal assets for generating non-tax revenues. According to official reports, non-tax revenues currently account for about 8 percent of regional/local budgets.

But even if they have no formal tax administration powers, regional and local governments have other means to make businesses pay subnational taxes. Media campaigns, audits and inspections, threats to bring in the audit of the Federal Tax Service or the Prosecutor's Office, and other forms of pressure on taxpayers often serve as effective fundraising tools. In addition, subnational governments often succeed in getting businesses to make in-kind contributions to local communities in exchange for tax breaks, budget loans or budget guarantees, land lease or sale, and other favours.

Issues of Tax Competition

As mentioned above, the tax autonomy of subnational governments is limited to the provision of tax breaks and the establishment of tax rates within the range established by federal laws. The two most important taxes that are regulated by subnational governments in terms of their tax rate are the Enterprise Profit Tax (EPT) and the Business Property Tax

Table 4
Tax assignment for various orders of government (2005)

	Determination of			*Shares in revenue (%)*			
	Base	*Rate*	*Tax collection and administration*	*Federal*	*State/province*	*Local*	*All orders*
Federal							
Enterprise profits tax	Federal	Federal	Federal	27	73		100
VAT	Federal	Federal	Federal	100			100
Excises on alcohol and alcohol-based products	Federal	Federal	Federal	50	50		100
Excises on gasoline and diesel fuel	Federal	Federal	Federal	40	60		100
Excises on alcoholic products, beer	Federal	Federal	Federal		100		100
Other excises	Federal	Federal	Federal	100			100
MET (fuel gas)	Federal	Federal	Federal	100			100
MET (hydrocarbons, exclusive of fuel gas)	Federal	Federal	Federal	95	5		100
MET (widespread minerals)	Federal	Federal	Federal		100		100
MET (other minerals)	Federal	Federal	Federal	40	60		100
Fee for the use of aquatic biological resources	Federal	Federal	Federal	100			100
Fee for the use of fauna	Federal	Federal	Federal		100		100
Water tax	Federal	Federal	Federal	100			100
Single social tax	Federal	Federal	Federal	100			100
Personal income tax	Federal	Federal	Federal		70	30	100
Tax on inheritance and gifts	Federal	Federal	Federal		100		100
Federal special tax regimes							
Single tax on imputed income	Federal	Federal	Federal	10		90	100

Table 4
Tax assignment for various orders of government (2005) (*Continued*)

	Determination of			*Shares in revenue (%)*			
	Base	*Rate*	*Tax collection and administration*	*Federal*	*State/province*	*Local*	*All orders*
Single tax levied under an applicable simplified taxation system	Federal	Federal	Federal	10	90		100
Single agricultural tax	Federal	Federal	Federal	10	30	60	100
State or Provincial							
Enterprise property tax	Federal	Provincial	Federal		100		100
Transport tax	Federal	Provincial	Federal		100		100
Tax on gambling business	Federal	Provincial	Federal		100		100
Local							
Personal property tax	Federal	Local	Federal			100	100
Land tax	Federal	Local	Federal			100	100

(BPT). The regional rate of the EPT, one of the largest tax sources of subnational budget revenues, which accounts for some 38 percent of total regional tax revenue, may vary from 13.5 percent to 17.5 percent, and the rate of the BPT varies from 0 to 2.2 percent.

In terms of real economic growth, establishing lower tax rates or granting exemptions from these or other taxes is hardly instrumental because long-term growth depends on investments. Favourable economic and political conditions attract greater investments than do short-term benefits. Besides, federal tax legislation that regulates the taxing powers of subnational governments changes almost every year, and there are no guarantees that low tax rates and/or tax exemptions granted by a regional government would remain in force even one year ahead.

Nevertheless, regions do benefit from setting lower tax rates because lower rates induce businesses to move their headquarters to these jurisdictions and to register as payers of the profit tax. By using transfer prices, such companies turn their headquarters located in domestic offshore zones into profit centres. Although offshore regions report high profits, they do not lose in terms of federal equalization. This is possible because the transfer allocation methodology used by the federal Ministry of Finance relies on economic performance data rather than on actual tax collections. The State Statistical Agency (*Rosstat*) registers economic performance (production) where it actually occurs rather than where production taxes are paid. Therefore, although the drain of businesses from other regions occurs only on paper, it significantly increases regional revenues.

Notable cases of tax competition include the Republic of Mordovia, which, in 2002, granted $700 million worth of tax concessions, whereas in 2002 its revenue-generation capacity (estimated by means of a methodology based on economic performance) amounted to only $130 million. As a region with low per capita fiscal capacity, the republic receives federal equalization transfers and capital transfers for regional development.

The scale of losses that regions can suffer if large taxpayers decide to move the registration of their businesses elsewhere is illustrated by the case of Sibneft. One of the largest oil companies in Russia, Sibneft, whose owner, Roman Abramovich, was the elected governor of Chukotka, set up an affiliated company, Sibneft-Chukotka, specifically for paying taxes in Chukotka. This generated a fourfold growth of regional budget revenues over four years. Later, the new owners of Sibneft refused to continue paying taxes to Chukotka and dissolved the affiliated company. Now they are considering shifting the registration of the parent company, which was originally registered in Omsk Oblast, to the City of St Petersburg. This will reduce the Omsk Oblast budget revenues by 60 percent.

FISCAL EQUITY AND EFFICIENCY CONCERNS

The existing assignment of revenue sources across levels of government creates vertical imbalance in the budget system of the Russian Federation, and this imbalance keeps growing over time. The gap between the richest and the poorest regions exceeds 280-fold in terms of per capita taxes collected. The upper revenue group comprises oil- and gas-producing regions, and the lowest revenue group includes the republics of the Northern Caucasus, whose fiscal capacities are affected by ethnic and/or religious strife, the predominance of the shadow economy, and a rapidly growing population.

Regional fiscal capacities vary dramatically, and so do geoclimatic conditions and distances from centres of production, leading to disparities in energy prices and prices of other inputs and, ultimately, to disparities in the cost of delivery of public services. The difference in the cost of living between the richest and the poorest regions is threefold, disparities in the costs of communal services are twentyfold, and the difference in the length of the heating season across Russian regions is ninefold.

To reduce the fiscal gap, the federal government allocates general-purpose (fiscal equalization) and other transfers to subnational governments. The number of subsidies, subventions, and other transfers that the federal government allocates every year is close to one hundred, as measured by the number of line items under the intergovernmental transfers section of the federal budget. The major types of federal transfers are equalization transfers, gap-filling subsidies, the Compensation Fund, co-financing of social programs, capital transfers, regional finance reform transfers, operating transfers to special territories, ad hoc subsidies, and transfers to closed cities.

Equalization transfers are formula-based, general-purpose grants. The Budget Code – the federal code of laws that govern public spending procedures across all levels of government in Russia – does not restrict the spending of this grant money to any specific purpose. But in reality these transfers are spent primarily on paying the wage bill and go by the name of "wage subsidies" in the parlance of regional finance officials.

Gap-filling subsidies, which were first introduced in 2004, compensate regions for implementation of federal policies leading to regional revenue gaps and/or expenditure increases (see Table 5). In 2004, these subsidies compensated regional governments for the federally mandated increase in wages in the public sector. In 2005, gap-filling subsidies had a three-part purpose: (1) to compensate for losses from changes in the equalization formula; (2) to compensate for revenue gaps caused by the reduction in the regional share in the oil and gas extraction tax, 100 percent federal retention of the water tax, and a 1.5 percentage point reduction in the regional component of the corporate income tax; and (3) to compensate for the devolution of vocational schools and so on. Note that the increase in the minimum wage in 2004 was not included in the list of purposes for allocating gap-filling subsidies in 2005.

Transfers from the Compensation Fund compensate regional governments for implementing federal mandates. These include (1) the rental subsidy granted to certain categories of federal beneficiaries (such as war veterans and victims of irradiation catastrophes), (2) benefits for blood donors, and (3) compensation of regional governments for civil status registration (all three are federal functions).

Co-financing of social programs partially compensates regional governments for a number of social safety net entitlements. In fact, federal laws have introduced most of these entitlements, so they can be interpreted as federal mandates. These include childcare subsidies and subsidies for victims of political repression, distinguished retirees, and individuals who worked in military enterprises during the Second World War. Subsidies for co-financing social safety net programs resemble mirror grants, but they do not create incentives for increasing the regional contribution: the federal government estimates the spending needs of the regions for implementing

Table 5
Vertical fiscal gaps

	Total revenue collected (in current US$ in millions – 2006)	*Total revenue available, including net transfers for that level of gov't (in current US$ in millions – 2006)*	*Expenditures (in current US$ in millions – 2006)*
National	273,000	248,000	171,000
Subnational			
state/provincial	106,000	98,000	93,000
local	25,000	58,000	54,000
All orders	404,000	404,000	318,000

federal mandates and transfers funds that cover a certain fixed share of this spending need. If the regions chose to contribute more, this would not make the federal government liable to increase its share in the total funding of social programs.

Capital transfers include transfers targeted for capital investments in the public sector (e.g., construction of schools, hospitals, and information technology). Regional finance reform transfers are awarded to regions through competition for prompt reform of public finance management. Participating regions must submit an action plan and demonstrate successful implementation of the plan in order to win the grant. The World Bank initiated the Regional Finance Reform program in 2000; currently, the World Bank and the federal government co-finance the program.

Operating transfers to special territories are subsidies to Chechnya and regions that have suffered from irradiation. Ad hoc subsidies include the annual Best Run City Award, grants to cities celebrating anniversaries, ad hoc compensation for federal mandates other than those covered elsewhere, and so on. Transfers to closed cities are general-purpose subsidies for military industrial centres as well as research and development centres. The federal government provides direct support to these cities rather than going through subnational governments.

Every year almost half of the total federal transfers (about $6,329 million) goes through the federal Fund of Financial Support to Regions as an equalization allowance for the low-income regions. Each year, sixty-five to sixty-eight regions out of eighty-six receive equalization grants from the federal government. Equalization grants are allocated through two windows. First, 80 percent of the total amount is allocated to all regions whose per capita fiscal capacity before equalization is less than the national average. The greater the difference between the national average and the regional per capita fiscal capacity, the greater the equalization grant allocated to that region. And second, the remaining 20 percent is allocated to the lowest-income regions in order to bring their fiscal capacity up to a certain uniform level.

The government used a formula-based approach for grant allocation to prevent regions from influencing the grant allocation process. Estimation of a region's fiscal capacity is based on value added by economic sectors, ignoring tax migration, a practice that is widely used by businesses. To account for differences in the demand for public services and input costs across regions, per capita fiscal capacities are adjusted by applying expenditure needs indices that account for price, demographic, socio-economic, geographic, climatic, and other objective factors that influence the per capita cost of providing the same public service in different regions.

Estimation of the per capita cost of public services relies, to a large extent, on the judgment of federal experts, which introduces a certain degree of opacity into the equalization formula, even if comprehensive statistical information is available.

Special federal transfers, such as compensation for federal mandates and certain capital transfers (these include subsidies for implementation of the Federal Targeted Program Reducing Disparities in Socio-Economic Development of Regions of the Russian Federation) are also allocated based on transparent formulas. Distribution of grants from the Regional Finance Reform Fund is also transparent, but distributable amounts are rather small.

The allocation of all other transfers remains non-transparent, and strong regions seem to have the power to negotiate the allocation of federal funds in their favour. For instance, the lion's share of federal transfers for implementation of regional development programs ends up in Tatarstan and Bashkortostan, two republics that are in the upper-income group of the regions, ranking fifth and nineteenth, respectively, in per capita fiscal capacity. The two regions used to receive two-thirds of the regional development grant pool, although their combined population is only 5.5 percent of the total Russian population. In total, the federal government allocates about 12 percent to 13 percent of its annual expenditure budget for support to the regions, and these finance about 16 percent of subnational government expenditures in Russia.

Size of the Grant Pool and Allocation of Fiscal Transfers

Different types of transfers are estimated differently, and the size of the total pool of federal grants to the regions is determined as a sum of these different types of transfers. Some types of transfers are adjusted for inflation, and others are not. For instance, for many years, the Best Run City Award has been equivalent to $3 million. By contrast, the size of the fiscal equalization pool is determined every year based on the figure from the preceding year, which is adjusted for inflation and changes in federal tax and budget legislation. Transfers from the Compensation Fund cover 100 percent of the estimated expenditure needs of the regions associated with implementing federal mandates. Apparently, there is no formalized methodology for estimating the need for financing the gap-filling subsidy since this subsidy was used for financing different needs in FY2004 and FY2005. Nevertheless, in this case too the Ministry of Finance presumably takes into account the figure from the preceding year.

Fiscal Disparities across Localities

The prosperity of a municipality almost completely depends on the local businesses or, better to say, on the businesses that locate their headquarters in the municipality rather than on the well-being of its citizenry. Therefore, disparities across localities are as dramatic (and even worse) as are those across regions.

The personal property tax generates a minor part of the overall local revenue due to the underdeveloped personal property market. And income tax (paid by employers) accrues to the budget of the locality where the employer is registered as a taxpayer rather than to the locality where the employees reside.

Typically, the presence of a strong and profitable business, such as an oil company or a liquor factory, allows the host municipality to prosper in comparison with its neighbours. The difference in the per capita fiscal capacity of the richest municipality of the region is 1.5 to two times as high as is the average per capita fiscal capacity across all municipalities of the region, and in oil producing regions this gap can be three- to sevenfold.

Most of the rural municipalities fall into the lowest income category as their taxable base is negligible (if they have one at all), and regional transfers generate 80 percent to 90 percent or more of their revenues.

For example, significant disparities across the 290 settlements of Stavropol Krai reflect the tax potential of rural versus urban settlements. The tax base of the former is far beyond that of the latter. Further, urban settlements (small towns) tend to drain labour along with income tax from rural areas.

Fiscal Disparities across Regions as a Matter of Political and Policy Concern

Given the significant variations between regional conditions and development opportunities, the fiscal inequality of regions is often taken for granted and is seen as something that would be impossible to change.

Despite ongoing increases in the volume of federal transfers, inequality between regions continues to grow, which calls for a revision of the equalization policy. The main concern is that the current policy reproduces inequality rather than providing regions with development incentives. So far, policy makers have discussed putting heavily subsidized regions under external financial management, but the first candidates that have been placed under external control are ethnic republics, which makes this issue extremely sensitive.

Allocation of Equalization Transfers and the Degree of the Resulting Equalization

The federal equalization transfers are premised on a formula-based assessment of the regions' fiscal capacity and current expenditure needs. The equalizing exercise results in the reduction of the gap in per capita revenue capacity between the wealthiest and poorest regions from about 100-fold to seventeenfold. The federal government does not take negative transfers from richer regions, but the new law on local self-governance contains provisions that allow regional governments to use negative transfers to equalize the per capita fiscal capacities of local governments.

Two out of five regions in the upper income group – Chukotka and Evenk – receive equalization transfers due to the exceptionally high expenditure needs attributable to their remote northern location.

Other Equalization Instruments

Allocation of equalization transfers is the main, if not the only, equalization instrument used by the federal government. Federal/regional shares in the co-financing of social programs depend, to some extent, on the fiscal capacity of the region in question. A portion of capital transfers is allocated based on a formula that captures the interregional inequalities in per capita availability of communal networks and social facilities, such as schools and hospitals, but this is a relatively small portion of capital transfers. Compensation for federal mandates is based on estimated expenditure needs and does not depend on the per capita fiscal capacity of the regions. In fact, allocation of such compensation enhances the inequality across regions. Direct investments of the federal government could serve as an equalization tool but, in fact, also contribute to inequality enhancement, as is demonstrated by their bias towards stronger regions, such as Tatarstan and Bashkortostan.

Transfers to Local Governments

The share of transfers in local revenues is about 30 percent to 80 percent. The Russian Federation Budget Code requires that regional governments allocate their equalization transfers to municipalities based on the localities' per capita fiscal capacities. However, regions customarily equalize local government capacities in order to maintain the existing social infrastructure. For instance, education expenditure needs are estimated by the number of schools and teachers rather than by the number of schoolchildren.

The Budget Code allows regions to use several equalization windows: one for equalization transfers, one for capital transfers, and so on. The choice of the equalization algorithm is up to the regions. The Budget Code provides for several possibilities: regions may choose to allocate grants from the regional pool to all municipalities (i.e., municipal districts/urban districts and settlements) directly, or they may choose to use a two-step procedure (i.e., to equalize municipal districts/urban districts at the regional level and then allow districts to equalize settlements). The majority of the regions are using the second approach because it means less work for them.

Impact of Fiscal Transfers on Efficiency and Equity of Service Delivery and Interjurisdictional Equity

Federal laws set the requirements and terms for most of the public services delivered by subnational governments in Russia. However, regions differ dramatically in terms of accessibility of services and per capita expenditures.

The diversity of Russian regions resembles the diversity of the countries in the world: there are megacities, oil regions, oriental-type appendages, northern territories with tribal relations, and so on. Equalization of all of those territories is impossible in principle, especially if the same approach is applied to all regions. The federal government's recent efforts to diversify its regional policy show that policy makers are aware of this problem. So far the search for new solutions has tended to focus on strengthening financial controls, including the introduction of external financial management.

CAPITAL FINANCE, PUBLIC MANAGEMENT, AND CORRUPTION

Financing Capital Investment

In the majority of regions in Russia, private business is the major investor in business as well as in social infrastructure development. This is explained not so much by the "good citizen" attitude of businesses as it is by the existence of high entrance fees to regional and/or local markets. Recent scandals around Ikea in Yekaterinburg, Voronezh, and St Petersburg; the Mega Trade Centre in the Moscow region; and so on, testify to this.

Federal capital transfers are a source of about one-fourth of all subnational public investments ($3,111 million out of $12,261 million in 2004).

Only 1.6 percent of subnational investments are financed with bank loans. Increased bond-related liabilities cover 13 percent of subnational investments, and proceeds from sales of regional/local assets add another 8 percent. All these sources cover not more than half of the reported investments of subnational governments. Thus, the conclusion is that at least half of subnational investments are financed from the regions' current own revenues. This has been made possible by the hike in the world oil price.

The market for regional bonds is small, although it exhibits a high growth rate: most of the regions have either issued or redeemed regional bonds in the last two to three years. Moscow and Moscow region's bonds prevail on the market, and, according to expert estimates, they account for more than 70 percent of total sales of regional securities.

The Budget Code restricts subnational borrowing by setting a limit on debt (the allowed debt cannot exceed the regional government's own revenues) and the deficit (the allowed deficit cannot exceed 15 percent of regional own revenue exclusive of proceeds from property sales).

Formally, the Budget Code allows foreign borrowing by subnational governments, but any such borrowing is allowed in Russian rubles only, which effectively prevents foreign lenders from entering this market. Nevertheless, as of the end of the first quarter of 2005 (the most recent data available at the time of writing), the aggregate debt of the subnational governments to international credit institutions was about $230 million.

The Budget Code does not restrict the federal government's borrowing in foreign currency. Subnational governments widely use sublending by the Ministry of Finance as an alternative to foreign borrowing. As of the end of the first quarter of 2005, these loans amounted to about $400 million.

Problems with Financing Capital Investments and Implications for Reform

Most of the federal government's capital expenditures are non-program expenditures that are scattered among regions and individual construction projects, thus giving rise to delays in construction. The federal government finances several thousands of projects, including those of local importance (such as water and gas network utilities).

Another problem with financing capital investments is that spending across levels of government in Russia is shared by type of expenditures – such as operating or capital – rather than by function or service. Subnational governments responsible for service delivery often do not have enough resources to bear the corresponding capital expenditures; instead, these expenditures are undertaken by the higher level of government – federal government in the case of regional functions, regional government in the case of local government functions. A one-year-based budgeting process contributes to the problem as no one can guarantee that financing for a capital construction project that spans several years will continue in the next year. It is hoped that medium-term budgeting, which is being introduced under the current state budget reform, will largely resolve this particular problem.

Fiscal Federalism Dimensions of the Public Management Framework

Many state functions are centralized at the federal level, and the federal government appoints the heads of its territorial branches. Either the regional governor or the legislative assembly of the region appoints the regional chief executive officials. Members of regional legislative assemblies and, until recently, governors were elected by a direct vote of the people and had a fixed term.

After the Beslan school hostage crisis in September 2004, the federal government took more serious measures to concentrate political power. Among the most controversial was the president's bypassing of direct governors' elections in favour of appointing them himself. As a result, governors have become integral to the national executive power, and political centralization has replaced decentralization of responsibilities (although the centralized state now exists in a deconcentrated form).

Corruption and Its Possible Causes

All studies of corruption in Russia agree on one point: the level of corruption is high. Leaving aside such considerations as historical traditions and low civil service wages, one may presume that one reason for the high level of corruption in the regions is the federal equalization policy. The regions tend to report lower revenues and to hide their revenue sources in the shadow economy in order to be able to claim a larger share of the federal equalization grants.

Corruption is also rooted in the unavailability of legal levers that would allow regional and local governments to adjust their revenues to their spending needs. Subnational governments in Russia have very limited tax-raising authority, which drives them into entrepreneurship, especially as they can use their administrative resources to efficiently oust competitors.

Corruption may get even worse thanks to the enactment of the new law on local self-governance. This law does not allow local governments to hold assets that are not directly related to the provision of the public services assigned to them. Local governments have started stripping themselves of such assets and transferring them to hastily created firms that, although not formally government-owned, are in fact controlled by the government.

THE WAY FORWARD

Russian statehood is going through a period of very rapid changes. The vertical line of power has been strengthened considerably under Vladimir Putin, while federalism seems to be growing thin. Is it just another swing of the pendulum or will centralist tendencies stay for good? It is difficult to say because these new developments are somewhat controversial. The new legislation upon which the federal government is working will devolve more state powers to the governors, but the president will continue to appoint those governors. The federal government has already delegated new federal functions to the regions, and it promises to add more. Monitoring of the governors' performance will be exercised by federal inspectors who report to presidential envoys in each of the seven federal districts as well as to the Main Control Department at the Administrative Board of the president.

Thus, Putin's strategy of federalism has become clear. The federal centre appoints regional authorities, delegates the federal functions that are supported with relevant funding, and keeps this spending under strict control. If these earmarked transfers are ever misappropriated and the situation in a region worsens, the president possesses the means to reverse it. There is a potential danger inherent in this strategy. Once the centre has started to exercise control over the execution of federal responsibilities by the regions, it may also be tempted to assume control of regional functions. The danger is quite real because the regions now carry out many additional functions that are not exempt from the federal centre's interference.

How was it possible to turn from decentralization to centralization – that is, to the unitary past? Why did the regions not put up some resistance? One of the explanations is that agreeing with the president's policy in modern Russia warrants a successful political or business career. Another is that, given heavy financial reliance on the federal centre, many governors consider accountability to the president to be more important than accountability to the voters. Besides, the taxable base in Russia's regions is created by businesses, not by citizens, and the governors seek to attract businesses rather than to improve the living conditions of households.

Fixing the assignment of revenue sources and sharing rates across government levels in the Budget Code (2004) as an alternative to annual revisions has lessened the fiscal dependence of subnational governments on federal government budget policies. However, it has not noticeably strengthened the fiscal autonomy of the regions. The same applies to the equalization transfer formula. On the one hand, formula-based transfers make cash flows to the regions more transparent; on the other hand, it is the federal government that devises the formula. Given annual amendments to the formula, the revenues of the regions have not become more predictable. In any case, experts have failed to notice some statistically meaningful correlation between changes in the independent variables describing the economic situation in a region (and its expenditure needs) and the resulting changes in the volume of the equalization transfer.

Today, there is no federal strategy in Russia to further fiscal federalism, and there is no unanimity about the prospects of political federalism. Most experts are of the opinion that subnational governments should have different spending obligations because of disparities in regional development, climate, ethnic traditions, and the like. Therefore, a return to the asymmetrical model of federalism looks almost inevitable. However, the wrapper will be different. In the 1990s, strong regions received additional powers under bilateral agreements with the federal centre, while the model discussed today provides for taking powers away from weaker regions.

Is it valid to say that the efforts to develop intergovernmental fiscal relations in the period between 1999 and 2005 were wasted because fiscal federalism will inevitably die away right after political federalism? Or could steps towards the financial autonomy of the regions be perceived as evidence that federalism is going to stay?

Is fiscal federalism possible without political federalism? And is political federalism possible without some degree of fiscal autonomy? Some experts believe that Russia's present return to a unitary system will not last – that fiscal federalism will pave the way for the further development of political federalism. They point to the greater financial autonomy of the regions due to the revenue sources – however scarce – assigned to them, the formula-driven allocation of equalization transfers, and several federal funds that have been set up to allocate targeted transfers to the regions. Others believe that fiscal federalism and local self-governance are impossible without true revenue autonomy and that fiscal federalism cannot co-exist with a vertical axis of executive power. In other words, the highly centralized authority in Moscow trumps the ability of the regions to exercise any real powers of their own. There is one thing upon which many can agree: in attempting to improve fiscal federalism, the country must not wait for the appearance of an ideal form of federalism.

NOTES

1 For more on revenue autonomy, see Michael Alekseev and Galina Kurlyandskaya, "Fiscal Federalism and Incentives in a Russian Region," *Journal of Comparative Economics* 31 (2003): 20–33; Galina Kurlyandskaya and Natalia Golovanova, "Decentralization in the Russian Federation," forthcoming in *Economic Change and Restructuring*; and Jorge Martinez-Vazquez, Andrey Timofeev, and Jameson Boex, "Reforming Regional-Local Finance in Russia," WBI Learning Resource Series, World Bank, Washington, DC, 2006.

2 For a historical overview of local self-governance in Russia, see Galina Kourliandskaia, Yelena Nikolayenko, and Natalia Golovanova, "Local Governments in the Russian Federation," in *Developing New Rules in the Old Environment: Local Governments in Eastern Europe, Caucasus and Central Asia,* ed. Victor Popa and Igor Munteanu, 161–264 (Budapest: LGI/OSI, 2002); and Irina Starodubrovskaya, *Analysis of Revenues and Expenses of Local Budgets* (Moscow: CEPRA, 2003).