CENTER FOR FISCAL POLICY

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Intergovernmental Reform in Russia 2000-2006[1]

Introduction

Russia is a state that enjoys diverse climatic, geographic, economic, cultural and historical conditions. As a result, people living in various regions have different preferences for public goods, while the federal center cannot effectively identify priorities for the population of each region. These are the arguments in favor of a highly decentralized governance of the public sector in Russia. On the other hand, the Russian regions vary considerably in terms of tax base and fiscal capacity. Great disparity in economic situation of the regions calls for the federal center to reallocate financial resources. The reallocation function of the budgetary system becomes even more important owing to the uneven economic growth of Russian regions and changes in their population sizes in the medium-term perspective.

The combination of arguments in favor and against decentralization requires from the long-term intergovernmental fiscal policy to be flexible enough to provide for a minimum level of public service financing in depressive regions and, at the same time, to stimulate economic growth in regions and municipalities demonstrating dynamic development. In order to achieve the optimal balance between the two goals it is necessary to accomplish a set of tasks including both a better assignment of expenditure responsibilities across the federal center, regions and municipalities and an improved allocation of revenue sources across the different tiers of government. At the same time,

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the structure of the IGFR equalization system should not create soft budgetary constraints. It also should minimize negative fiscal stimuli on the part of subnational authorities.

Historical Overview

The Constitution of the Russian Federation (dated 1993) provides for a list of exclusive responsibilities of the federation and a list of joint responsibilities of the federation and the subjects of the federation (here I will refer to them as regions). The list of joint responsibilities contains only general government functions (such as “education”, “healthcare” or “welfare”) without further breakdown into primary, secondary, and higher education or into first aid, ambulance, general and specialized healthcare.

In the 1990s, after the collapse of the Soviet socialist system with its centralized government, the division of spending responsibilities between the federal center and regional governments followed the allocation of property rights on public institutions to be financed by federal or regional authorities rather than the division of service delivery functions. Thus, some kindergartens were run and financed by the federal government, while others - by regional and municipal governments. On the other hand, the universities could be owned and run by any level of government. The same applied to any other government function: the obligation to perform a function was substituted by the obligation to provide adequate spending to a public institution assigned to a specific government body. Revenues of a particular government depended fully on the amount of expenditures it needed to finance its public institutions. The allocation of revenues across regional governments remained the privilege of the federal government. It was also the federal government that introduced or withdrew taxes (including those retained by a regional or a local government) and collected all the taxes. Regional and local governments had only the right to change tax rates (within federal limits) of a number of regional and local taxes which could cover less than 10% of their total expenditures.

The rest was funded through shared federal taxes and gap-filling cash transfers.

The major shared taxes in the 1990s were the personal and corporate income taxe and the VAT. The federal government was sharing these taxes with regional governments on the origin-based principle which means that a regional government was permitted to retain a certain share of taxes generated by taxpayers registered in that region. Before 1994, shares were set individually for each region and changed every year. Individual shares of federal taxes were subject to negotiations between the federal and regional governments.

All the standards of service delivery were prescribed by the federal legislation and appeared in the federal legislation as unfunded federal mandates. The greatest burden for regional governments were child allowances and in kind benefits to war veterans, invalids and other eligible groups of citizens (including, by the way, federal government officials like policemen, judges, the military).

The benefits consisted mostly of free or low-price provision of housing and utilities services and free public transportation.

Because both tax revenues and spending responsibilities were assigned to each region by the federal government, the amount of an equalization (or rather gap-filling) transfer was calculated as the difference between estimated tax revenues and estimated spending needs. Both estimates regarding a particular region were negotiated between the federal Ministry of Finance and the relevant regional government. When calculating transfers the Ministry of Finance takes into account consolidated revenues and expenditures of a region, which means revenues and expenditures of the regional government together with those of all municipalities in its jurisdiction.

Components of the IGFR Reform

Starting from 2000, Russia went through a period of a radical reform of intergovernmental fiscal relations. The results of the reform were as follows:

- the budgetary system of the RF subjects has become more transparent,
- powers and expenditure responsibilities have been delineated between the federal, regional and local governments,
- stable revenue sources have been assigned to each level of government,
- intergovernmental transfers both to regional and local governments have been designed according to formula,
- regional and local finance management has improved.

This reform included the following four components:

<u>The first component of the IGFR reform:</u>

Clear and symmetrical allocation of spending responsibilities across federal, regional and local governments.

<u>Functions assigned to regional governments:</u>

providing funds to municipalities for pre-school, primary, secondary and after school education

vocational education

specialized hospitals (TB, cancer, psycho etc.)

construction and maintenance of regional roads and other infrastructure

welfare services to elderly and handicapped

children allowances, allowances to victims of Stalin's regime and low income households

orphanages

regional public libraries

cultural and sport events

environment and nature reserves protection

inter-city public transportation

regional museums

veterinary control

terrorism control

intergovernmental relations with local self-governments

This also included demarcation of joint responsibilities. Now each level of government is responsible not for funding a specific public institution but for provision of particular public service to its population.

Though the Constitution has not been changed, the new federal legislation provides for a more detailed list of functions to be performed by regional and local governments.

<u>The second component of the IGFR reform:</u>

Distinction between the three types of responsibilities:

1) regulate (or set standards for) public service delivery responsibility,
2) provide adequate funding for this service delivery,
3) deliver the service itself.

This distinction permitted to get rid of unfunded federal mandates. From now on the detailed service delivery regulation and the responsibility to provide adequate funding for these purposes must remain at the same level of government (either federal, regional or municipal). The service delivery function may be transferred to a lower level of government but only together with the special purpose (or strictly conditional) grant or transfer.

To a certain extent, the elimination of unfunded mandates was executed through funding of previously unfunded federal mandates. To provide adequate funding for mandates (from now on - functions delegated to the regional level[2]), the federation concentrated additional revenues in the federal budget. It was done by reducing regional shares in federal taxes. These revenues are transferred

[2] Mostly subsidies and benefits to war veterans and Chernobyl victims

back to regions as special purpose transfers. Because the functions are delegated symmetrically to all regions, special purpose transfers also go to every regional government, whether it is wealthy or poor.

Another way of unfunded federal mandates elimination was a considerable reduction in regional competences extensive regulating on the part of the federal center. . From now on the federal legislation can only set a framework regulation of regional competences while detailed standards are to be set by regional laws. To introduce this change, the Russian National Parliament had to adopt amendments to about 200 federal laws. Among the abolished federal mandates the major one concerned federal regulation of regional and municipal public employees’ wages. Now each region is free to set its own wage rates for teachers, doctors, government officials etc.

As the RF Constitution does not permit to reduce, over time, the amount or the quality of public services, regional governments appear not to be fully free in setting their own standards of functions transferred to them from the federal level. As a consequence, the federal unfunded mandates continue to exist.

Taxes assigned to regions:

- regional corporate property tax
- regional tax on car owners
- regional tax on gambling business
- 73% share of federal corporate income tax collected within the region (regions may vary its rate within 4% points)
- 70% share of federal personal income tax collected within the region
- 100% share of federal excises on liquor, wine and beer
- 50% share of federal excises on technical alcohol
- 60% share of federal excises on gasoline and diesel fuel
- 5% share of federal oil and gas extraction tax
- 60% share of federal other minerals extraction tax
- 100% share of federal tax on inheritance and gifts
- 90% share of federal single tax levied under the simplified taxation system
- 30% of federal single agricultural tax

The third component of the IGFR reform:

Symmetric assignment of revenues across the levels of government and fixing equal shares of federal taxes to regions on the permanent basis.

The assignment of taxing powers and shares of shared taxes across the levels of government followed the assignment of spending obligations. The quantitative assessment of transferred responsibilities from one level of government to another permitted to estimates the needs for financial resources of each level of government. Accordingly, regional and local governments received the power to set rates (within federal limits) on a prescribed number of taxes and were guaranteed the right to retain equal (across each sub-national level) shares of specific federal taxes collected within their borders.

The fourth component of the IGFR reform:

Introduction of a formula based vertical equalization mechanism.

Each regional government with below the national average fiscal capacity is eligible for an equalization transfer from the federal budget. The vast discrepancy in per capita tax revenues results in the fact that 75% of Russian regions fall into this category. The total amount of the equalizing fund constitutes about 6-7% of federal budget expenditures (or 1% of GDP).

The size of a transfer to a particular region depends on the region's fiscal capacity and the gap between it and the national average. The transfer formula takes into account only official statistical data collected independently, with no influence on the part of regional or federal authorities. The regional tax capacity estimate is based on per capita Gross Regional Product data. The per capita tax capacity is then adjusted for regional differences in costs of public service provision. Introduction of this objective transfer formula has put an end to negotiations between regional governments and the federal Ministry of Finance. Unfortunately, the Ministry of Finance introduces changes into the transfer formula every fiscal year, which results in unpredictability of the transfer amount due to every region.

Equalizing transfers constitute only half of intergovernmental transfers. The federal government provides regions with other types of financial assistance, such as matching grants for implementing federal welfare policy, transfers for investments in public infrastructure and transfers compensating regional losses due to reassignment of functions and revenues across the levels of government. These transfers are much less transparent and are often used by the federal government as instruments to interfere into regional affairs.

Composition of Regional Revenues

In FY 2005, an average Russian region (regional plus municipal governments) was only 15% dependent on federal transfers. Another 35% of its revenues were shared federal taxes, about 30% – the corporate income tax (where regional government can manipulate tax rate), about 10% – regional and municipal taxes, and about 10% – revenues from market sales of goods and services.

Nevertheless, in poorer regions the share of federal transfers goes up to 80% of their revenues. Still, fiscal equalization permits to reduce regional per capita revenue gap from 80 fold to only 12 fold and to bring the poorest region from 13% of the national average to 60%. The richest region exceeds the national average after equalization by 4.5 fold because horizontal equalization does not include negative transfers from richer regions in favor of poorer ones.

Intergovernmental Fiscal Relations between Regional Governments and Municipalities

The intergovernmental fiscal reform in Russia was coupled with the reform of local self- governance. The new federal law (2003) introduced two levels of local self-governance including (i) municipal raions (districts) and (ii) municipal urban and rural settlements (small towns or villages). Bigger (municipal) cities represent the third type of local self- governance combining functions (and revenues) assigned by the federal law both to settlements and to raions. 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 on organization of local self-governance within their boundaries.

Functions assigned to municipal settlements:

- electricity, heating, water, gas , and fuel supply;
- construction and maintenance of municipal housing (for low income households);
- city/village libraries;
- basic fire protection;
- street lights;
- public transportation within city/village;
- recreation, cultural and sport events;
- cemeteries;
- waste collection;
- city/village road construction and maintenance;
- parks and gardens;
- teenagers' recreation.

Taxes assigned to municipal settlements:

- municipal land tax
- municipal personal property tax
- 10% share of personal income tax
- 30% share of federal single agricultural tax

Functions assigned to municipal raions:

Own functions:

- inter-village electricity and gas supply;
- inter-village public transportation;
- construction and maintenance of inter-village roads;
- municipal police;
- environment protection;
- general hospitals, maternity care and ambulance;
- raion libraries;
- recreation, cultural and sport events;
- waste utilization.

Delegated functions funded by region:

- pre-school, primary, secondary education, supplementary after classes education;
- birth, death and marriages registration.

Taxes assigned to municipal raions:

- 20% share of personal income tax
- 90% share of federal single tax on imputed income
- 30% share of federal single agricultural tax

The federal law strictly defines the scope of local self-governance, although regional governments may delegate to local governments some of regional functions together with resources to perform them.

The share of intergovernmental transfers in local revenues varies from about 30 to 80 %.

The federal legislation allows regions to use the same kinds of transfers as the federal government is using when providing financial assistance to regions. The equalization algorithm is up to regions, though the federal legislation provides for a number of regulations. It requires from regional governments to allocate their equalization transfers to municipalities based on per capita fiscal capacities. In reality, however, regions customarily equalize local governments' capacities 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. Regions may choose to allocate grants from the regional pool to all municipalities (i.e., municipal raions, municipal cities and municipal settlements) directly or use a two-step procedure (i.e., equalize municipal raions and urban districts from the regional level and then allow raions equalize settlements). The majority of the regions are using the second approach (popular earlier) because it means less effort.

The Sub-national Debt Issue

Currently, the regional excessive debt issue does not seem to be a problem in Russia. There are at least two reasons for this. First, following the 1998 financial crisis when a number of regions found themselves on the edge of bankruptcy, very severe limits on regional borrowing and debt amounts were included into the federal legislation. The allowed debt was not to exceed a regional government's own revenues, and the allowed deficit was not to exceed 15 % of regions' own revenues exclusive of proceeds from sales of property. Another reason for the low level of regional debt is the world oil price hike that increased regions' tax revenues and permitted them to finance about half of investments from own current revenues. The second largest source of all subnational public investments are federal capital transfers (25%). Only 1.6 % of subnational investments are financed with bank loans. Increase in bond-related liabilities covers 13 % of subnational investments and proceeds from sales of regional/local assets add another 8 %.

As a result, since the end of the 1990s regional governments' debt burden has continued to   reduce to constitute today less then 2% of the GDP. The ratio of the consolidated regional debt to regional budget spending constitutes 15%. The City of Moscow whose spending accounts for roughly 20% of total regional government spending is responsible for the bulk (25%) of the total regional governments' debt.

The federal Ministry of Finance carefully monitors the debt and deficit parameters of regional governments and is planning to pass an insolvency law that would require implementation of emergency financial management controls in case the debt limit is exceeded.

It should be noted that that the officially reported figures on regional governments' debt and budget deficit are estimated on the cash basis and do not take into account accrued liabilities. Public employee wage arrears carried over from previous years and/or overdue debts of public enterprises (accounts payable), though not shown in budget execution reports, still constitute in some regions a sizable share of regional governments' liabilities. Thus sub-national wage arrears in mid and late 1990-ies increased 2 % of GDP but recently, due to a favorable economic situation, have shrunk to 0.01 % of GDP.