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To recentralise or decentralise – some recent trends in Russian fiscal federalism

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Abstract

The paper gives a brief overview of the evolving fiscal federalist relations in post-Soviet Russia from the early 1990s up to recent changes in 2004. Since the initial period of disintegration and the "parade of sovereignties" in the mid-1990s, the tide has clearly turned in favour of central power. The authors describe and discuss the main administrative reforms in this area initiated during Putin's presidency. The paper also offers a characterisation of regional finances in terms of revenues, expenditures and transfers in recent years. The tendency towards recentralising economic and political decision-making is clearly observed.

Keywords: Russia, fiscal federalism, regional policy

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1 Introduction

Fiscal federalism concerns the distribution of power and the allocation of responsibilities among various levels of governmental administration.[1] Reasonably realised, fiscal decentralisation should promote efficient provision of public services, diminish regional disparities and contribute to political and economic stability. While proponents of fiscal decentralisation theory emphasise the positive effects of fiscal decentralisation on economic growth, empirical studies on the subject show mixed results and suggest that the link between fiscal decentralisation and growth is by no means direct. Moreover, there is no single unequivocally preferable or ideal model for decentralising; many factors seem to determine the optimal degree of decentralisation.[2]

While decentralisation in Russia has been a difficult, time-consuming process, it is generally conceded that clear, equitable principles that allow efficient governance are essential for a country with such a large area and population. Thus, during the last fifteen years Russia has pursued replacement of action models from the Soviet period with a suitable new model.

The election of Vladimir Putin as president in 2000 brought a shift in relations between the federal centre and the regions. Putin felt that the wide powers given to the regions during the Yeltsin administration in 1990s induced highly imbalanced development. Many international observers and financial institutions such as the IMF also remained critical of the inefficiency of Russia's public sector and fiscal federalist relations. As a result, Putin chose a strong centre-led model. This has become apparent in reforms of administrative structures and fiscal relations. Russia's administrative reforms have aimed at curbing the power of regional leaders and cutting back contradictory regional legislation. In the fiscal sphere, the federal centre has increased its power in imposing taxes, determining the tax bases and setting tax rates. During Putin's administration, the share of tax revenues the federal centre receives has grown.

This overview is organised as follows. Chapter 2 summarises developments in 1990s and serves as an introduction to the subsequent chapters. The confusing period under President Yeltsin is marked by the mixture of views on how to proceed after the collapse of Soviet Union. In practice, no single reform program ever emerged to guide the way; decisions were made spontaneously and led to quite sporadic development. Chapter 3 describes the political changes initiated by President Putin that lay the overall framework for the relations of centre, regions and municipalities. The development of fiscal federalist relations during Putin era is reviewed in chapter 4. Chapter 5 concludes.

[1] In Russia's case, this means a federal centre, regions and municipalities (local level).

[2] For a good overview of fiscal federalism research, particularly the link between fiscal decentralisation and economic growth, see Breuss & Eller, "Fiscal Decentralisation and Economic Growth: Is There Really a Link?" CESifo DICE Report 1/2004, 3-9.

2 A new Time of Troubles – developments in the 1990s

2.1 The Soviet legacy

A dictionary definition of a federation would be a league of states, each largely autonomous. The Russian Federation is something else. The borders of regional divisions date from the Soviet era and were originally planned in the context of Lenin's national policy, under which most Russian national republics came into being. The Stalinist era and the Second World War led to changes in regional borders in line with the needs of new policies. Further refinements took place during the Khrushchev era. Thus, Russia's present 88 regions are essentially administrative areas defined by the federal government; they do not necessarily reflect the historical and cultural differences among regions. Despite their geographic size, most regions are economic midgets.

The federal fiscal system was highly centralised throughout the Soviet era. Development plans of one year and longer formed the core of economic planning. Other plans, including the various administrative-level budgets, were subsidiary to the development plans of the state planning committee Gosplan. Even the federal budget was often little more than a tool for guaranteeing fulfilment of the plan's quantitative targets. Fiscal policy thus played a passive role in economic policy, subordinate to economic development plans.

In the 1970s and 1980s, federal budget revenues derived mainly from four sources: transfers from companies, turnover taxes, foreign trade revenues and income taxes. Other sources of finance included loans from the central bank, personal savings accounts and a limited issuance of federal government bonds. Soviet republics received varying portions of these revenues. The exception was earnings from foreign trade, which were solely at the disposal of the central government. Allocation rules for the other budget revenues varied from year to year and according to each republic's level of revenues. Expenditures for defence, security, legal system, support of foreign trade and many types of investment were covered by the federal budget. Republics were mainly responsible for social welfare expenditures. The intended level of expenditure was the starting point for the plans, and revenues were calibrated accordingly. Budget deficits for lower-level governments were financed by revenue transfers from higher administrative levels. Only the budget of the Soviet Union itself could be in deficit, and even these deficits were apparently of little consequence for the real economy throughout virtually all of the Soviet era. The huge budget deficits of the late 1980s disturbed the balance of the monetary sector at the start of the 1990s. This was reflected in the performance of the real economy.

Fiscal federalism issues were prominent in the disintegration of the Soviet Union. Russia, along with Ukraine, was the first Soviet republic to end its revenue transfers to the federal government budget. As other republics followed suit and political pressures for independence increased, disintegration of the Soviet Union became a done deal. Yet in the coming years, many were to wonder if another *smutnoye vremya* – a Time of Troubles – had arrived.

2.2 Disintegration (1991–1993)

In terms of the development of Russian fiscal federalism, the 1990s were splintered. Regional level aspirations led the country's parts in different directions, while regional inequalities increased. It was common for republics to strive for independence. In fiscal matters, too, there was striving for maximal regional decision-making power. Many proposals called vociferously for an end to the highly centralised system. Leading the charge were regions rich in natural resources – Tatarstan, Bashkiria and Sakha. Their example was followed by many other republics. Amid the political chaos and in an attempt to hold the country together, the central authorities tried to accommodate the regions. This sentiment was well reflected in President Yeltsin's comment, "Grab all the power you want."

While breaking out of the highly centralised system was inevitable, the desire of republics for autonomy soon got out of hand. In the early part of the decade, regional leaders took maximal advantage of their position in the chaotic circumstances. In many of the regions, laws, decrees and taxes were determined locally, and taxes and other mandated payments were not turned over to the central government.

For Russia, the struggle to define the relationship between centre and regions, the allocation of powers and responsibilities, stretched through the 1990s. In the first half of the decade, efforts focused on getting a federation agreement and supplementary bilateral agreements. Although these agreements failed in practical terms, they are noteworthy. The federation agreement of 1992 set up a framework for decision-making among the centre and regions; it was signed by all regional entities except Chechnya and Tatarstan. The agreement favoured republics at the expense of other territorial entities and conferred e.g. foreign trade rights and local mineral rights. For historical and other reasons, the republics' independence aspirations were seen as a particularly serious threat to Russian unity. In the aftermath of Soviet dissolution, it was considered a real possibility that Russia could disintegrate completely.

Following the federation agreement, a constitution was approved in 1993 and a few bilateral agreements were concluded between the centre and regions. The constitution seems to have been purposely worded very loosely to allow the most favourable interpretation for the situation at hand. The idea was to amend the constitution later to make it more precise, but so far this has not been done. Bilateral agreements had the effect of increasing regional inequalities. They specified, inter alia, cash flows between each region and the centre, as well as each region's rights and obligations. Bilateral agreements were typically valid for several years at a time. Typically, republics in the strongest financial condition were able to negotiate for themselves the most advantageous agreements, securing e.g. rights to tax revenues collected in their own territories for the purpose of financing specific obligations. This gave rise to the concept of *asymmetrical federalism*, a sort of Orwellian federalism under which some regions were more equal than others in spite of the constitutional requirement of equal treatment for all regions. President Yeltsin claimed that bilateral agreements strengthened Russia by acknowledging a particular region's uniqueness and independence. From the perspective of public finances, however, decentralisation of governmental powers on the basis of differing and secret bilateral agreements was a recipe for disaster. To be effective, fiscal federalism requires transparency and consistent game rules.

The lack of a clear framework for centre-region relations became obvious in the 1990s in connection with fiscal relations. Making changes to the tax system, another Soviet legacy, in the midst of ongoing economic reform proved a non-trivial task. Looking back, it may have been wiser to first dismantle the tax system and designate regional and local revenue sources. In the early 1990s, regions and local governments had no significant sources of revenue themselves; their financing came either via direct revenue transfers from the federal budget or via local collection of federal taxes. In the absence of clear rules, grants to the regions, especially in 1992–1993, were usually lump sums allocated via political negotiations, i.e. *bargained tax sharing*. The initial goal was to shift to the regions those social-sector obligations that had formerly been handled by the central government, even though the regions had little fiscal autonomy. This gave rise to the *unfunded mandate* problem – the transfer to the regions of numerous obligations that they were unable to discharge on the basis of their own revenues.

2.3 The golden era of regional power (1994–1997)

After the collapse of the Soviet Union, President Yeltsin's initial interests as regards the central government centred on framing the key elements of economic reform. In a cabinet meeting in February 1993, Yeltsin proclaimed the government lacked a regional policy. He added that he did not simply mean that the formation of a regional policy was still in progress, but precisely that no such policy existed.

Perhaps one could fairly accurately characterise the overall aim of the centre vis-à-vis the regions as a desire to keep the country united and have the influential reformers loyal to Yeltsin displace the old party bigwigs. Under the new constitution, each region was entitled to send two elected representatives to the new parliament's upper chamber – something particularly important given the turbulent conditions of the autumn of 1993.

Besides formal agreements, practical attempts at cooperation between the centre and regions also started in the mid-1990s. Regions initially established their own alliances for promoting their mutual interests vis-à-vis the central government. In summer 1994, the parliament and regional alliances concluded a cooperation agreement under which representatives of the regional alliances could express opinions on legislation affecting the regions (including budget and tax laws). It was further agreed that regional alliances would handle regional implementation of federal development programs, a move aimed to giving more weight to regional perspectives within the decision-making process. However, the practical importance of the agreement was diluted by the fact that the push by individual regions for autonomy and furthering their own interests often took precedence over the interests of the regions as whole. Moreover, the newly created regional alliances did not constitute a serious political force.

Those opposed to the movement towards a market economy began to garner support. The parliamentary elections in December 1993 and regional council elections in 1994 demonstrated the strength of the old party representatives. Against this background, Yeltsin needed to gain the support of regional leaders for the upcoming presidential election in summer 1996. The central government then tried to employ subsidies, to undermine the opposition communists, agricultural party, and liberal democrats (Zhirinovski). Treisman (1998) observes that federal transfers were allocated to those regions that had previously voted for Yeltsin's opponents. The president's regional representatives were given additional powers covering e.g. federal assets and monitoring of the use of federal subsidies to the regions.

As the fiscal autonomy of regions began to increase, rules for dividing tax revenues between the centre and regions began to solidify and were strengthened each year in connection with the federal budget. Previously changes in such rules, particularly in VAT allocation, had occasionally resulted in massive extra-budgetary transfers to regions.

The practical modifications and tightening measures also stemmed from the federal government's efforts to stabilise the macroeconomy. After 1995, the central bank slowed the rouble printing press and it became easier to allocate financial aid to needy regions and enterprises. Regions were given the right to levy local taxes and reduce regional shares of taxes on enterprises. Regions sometimes carried things to the opposite extreme by seeking to maximise their tax revenues through adopting as many taxes as possible. In many economic respects, the jungle of small taxes and fees provided ample opportunities for bargaining between taxable units and regional governments and for overt corruption. In other ways, too, a messy tax system became even more overblown.

Initially, the aim was to allocate increasing amounts of federal subsidies to regions via a regional fund established in 1994. The fund had the same goal in principle as all federal revenue transfers in the 1990s, i.e. to mitigate inter-regional income disparities. However, achievement of this goal was significantly hampered by the fact that nearly all regions were entitled to aid from the fund. Thus, monies dispensed from the fund were not generally sufficient to even out inter-regional income differences. More importantly, over time it became apparent that most of the support flowed through unofficial channels. Bilateral bargaining between centre and regions continued, motivated by the possibility of influencing fund dispersals.

2.4 Towards recentralisation (1998–2000)

Increased political and economic power of the regions transformed Russia into a fairly fragmented marketplace by the end of the 1990s. Public finances were characterised by chronic deficits and regions were issuing both domestic and foreign debt to finance their expenditures. An increasing number of domestic and foreign observers, as well as international organisations such as the IMF, focused on the urgent need to reform the public sector. Fiscal federalist relations were often mentioned as the top priority.

Under increased pressure to reform the country's inefficient and chaotic fiscal federalist relations, a government reform program was approved in 1998. Although implementation ceased with the economic crisis of August 1998, the crisis itself may be regarded as a watershed in fiscal federalist relations. The crisis hit hardest the regions that had been the most active in promoting their own deals with the federal centre. Moscow City, Tatarstan and Leningrad oblast, to mention a few, ran into great difficulties servicing their foreign-currency-denominated debt. In the immediate wake of the crisis, several regions imposed restrictions and quotas on exports of foodstuffs to other regions. These domestic export restrictions highlighted the fact that a largely uncontrolled decentralisation had severe negative effects on economic development. Already the 1999 budget increased the centre's share in total revenues and expenditures and foreign borrowing was prohibited for all sub-federal units. The long-overdue creation of a federal treasury was finally under way.

During the 1999–2000 electoral cycle, regions attempted to present themselves as a viable alternative to the federal centre through the creation of the Fatherland-All Russia faction. Nevertheless, the Kremlin's new party, Unity, emerged victorious. Regional leaders absorbed the lesson quickly, expressing their willingess to cooperate with the party in power. Finally, the resumption of the war in Chechnya pushed any remaining interest in discussing independent republics to the back burner.

3 Putin's reforms – back to law and order?

3.1 Federal Districts and reforming the Federation Council

Immediately after assuming office, President Putin initiated two reforms aimed at curbing the power of regional leaders and eliminating contradictory regional legislation. In May 2000, the federation was divided into seven federal districts, the borders of which coincided with country's military districts. There was no clear economic rationale for the borders of the new districts, and it has been argued that the borders were intentionally drawn so as to effectively end the economic and political cooperation that existed between certain powerful regions, notably those in the Urals federal region. The composition of the Federation Council was also modified.

Each new federal district was to be headed by a presidential representative (*polpred* or PR) nominated directly by the president. Simultaneously, the system of regional representatives created under Yeltsin was replaced by new presidential representatives authorised to appoint a federal inspector for every region. Observers at the time highlighted two potentially worrisome features of the new institution. First, the change created a new governance structure based on presidential decree that completely bypassed the government and the Duma. Second, the new structure was accountable only to the president. This latter aspect grabbed most of the attention at the time. Indeed, apart from a single represenitive, all of Putin's appointees had backgrounds in key power structures (e.g. the FSB, the military). The appointments also reflected Putin's own background and raised concerns that security was getting precedence over economic, administrative and social issues.

The representatives were tasked with coordinating the activities of all federal agencies (e.g. the FSB, tax policy and state television branches) in their district, as well as assuring that a "dictatorship of law" would prevail in their regions. In practice, this meant bringing regional laws into line with federal legislative and constitutional norms – something at which the PRs proved fairly successful. The value of the achievement, however, is somewhat questionable given the minuscule role laws play in Russian policymaking. Some observers, e.g. Reddaway-Orttung (2004), argue that the single most important contribution of the PR institution is that it reduced the influence of regional governors over key personnel appointments in federal agencies. In the late 1990s, a governor could get his favourite nominated to a particular post – even to the regional head of federal security organs.

The second large reform was directly targeted at the status of regional governors. A new law adopted in summer 2000 changed the composition of the Federation Council, leaving governors and heads of the regional legislatures without seats in the upper chamber. Instead, half of the members of the Federation Council were to be nominated by regional legislatures and the other half by governors. Top regional leaders were stripped of their full legal immunity, access to governmental offices and information they had enjoyed as chamber members.

The most visible consequence of the reform is that the Federation Council has become a supportive ally of the president's legislative proposals. Occasions where the Council has opposed drafts passed by the Duma have decreased significantly since 1999.

The two laws were consistent with the series of reforms Putin initiated to reduce the rights and autonomy of regional officials. An accompanying law gave the president a theoretical possibility to remove a governor that violated the constitution or committed a serious crime. As removing a governor is an extremely lengthy process, the law's main effect was psychological. In any case, governors were no longer untouchable sovereigns.

The new law on political parties in 2001 banned regional parties. The new law on interior ministry enabled the president to nominate regional heads of police over the objections of the governors. The new tax and budget laws changed revenue sharing rules in favour of the federal budget.[3]

3.2 The Kozak reforms

In summer 2001, the president created a new federal commission on the division of competences among levels of power in the Russian Federation. One of Putin's closest aides, deputy chief of staff Dmitri Kozak, was nominated to head the commission. What came to be known as the Kozak Commission was ordered to prepare recommendations for division of responsibilities among different levels of the public sector and ways to reform the local government system. As a byproduct, the commission's task list included revising existing bilateral treaties, and screening and eliminating regional laws that violated the constitution. In spite of initial resistance by governors who saw the Kozak Commission as a vehicle for further centralisation, the commission's work continued. The first drafts of its work were made public in October 2002 and two laws on the reform of regional and local government, respectively, were submitted to Duma with strong backing from the president in early 2003. Although the laws were approved in September 2003, they will not take effect until January 1, 2006.

The laws aim to eliminate to the greatest extent possible responsibilities jointly managed by the federal and regional authorities (Constitution, article 72). Instead, one level of government will be assigned full responsibility for a particular item. Further, the reform calls for assigning taxes and other revenues to one level and fixing in law the sharing rules for the remaining taxes. The new laws also define how the president may dismiss a governor or dissolve a regional assembly. Similar rights are given to governors vis-à-vis local leaders.

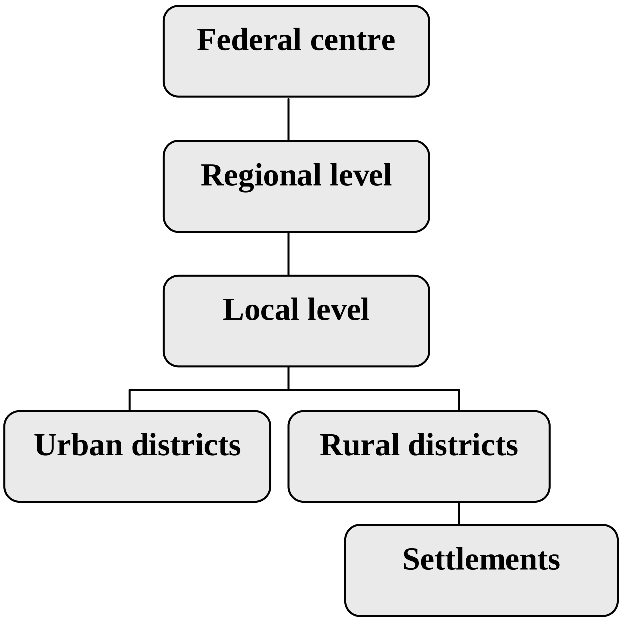
The consequences of the "Kozak reforms" are yet to be seen. The new law on local self-government, when implemented, will cause major changes on the sub-regional level. The law aims to offer local governments clearly assigned responsibilities, end the practice of unfunded mandates and give them their own, predictable sources of income. Compared to the current quagmire of juridical and functional confusion and bargaining, this sounds like a textbook model a reform of fiscal federalist relations. Implementation, however, is another matter.

The new law mandates the creation of a two-tier level local government with a fixed set of functions and revenues within every region. The bottom level consists of settlements (*poseleniya*). The second-tier local government, namely rural and urban districts

[3] Remington, 2003.

(*munitsipalnie raiony* and *gorodskie okruga*), will replace what we refer to here as municipalities (see Figure 1). For some regions, the federal law is merely a formalisation of regional reality; for others, the law will cause profound administrative reforms. Of course, one can question the wisdom of creating thousands of additional units of local government responsible for service provision – especially in large, sparsely populated regions. Further, the settlement level is entitled to a locally elected head, while at the district level the elected major will only have ceremonial function. Districts will be managed by a "city manager" whose appointment is determined at the regional level.

Figure 1. The new administrative division of the Russian Federation.



The adoption of the Kozak reforms calls for changes to several laws on the budget and tax codes. The Tax Code amendments, for example, are designed to clarify the allocation of taxes to federal, regional and local levels. The general aim is to give at least two taxes exclusively to each of the three levels. The amendments to the Budget Code include the introduction of a temporary administration up to one year of a region (locality) if it accumulates overdue debts corresponding to up to 30 % of its budgetary income. This provision, however, would not come into force until 2007.[4]

3.3 Reducing the number of the regions

As mentioned, Russian regions are administrative units that have existed with their current borders only about six decades. Unlike other large states such as the US, Canada, Brazil and China, the Russian federation is composed of many regions that are relatively small in economic and population terms. Consequently, it is hardly surprising that the federal authorities, wishing to establish clear and manageable vertical lines of power, have

[4] OECD, 2004.

encouraged discussions about the optimal number of regions in the Russian federation. As far as we can tell, however, nobody has proposed increasing the number of regions; the discussion is invariably about how and when to combine existing regions into larger administrative units. Merging two regions into one, even in technical terms, is a prodigious process. It requires a constitutional amendment backed by referendums in both regions.

The sole merger to date is that of the Perm region and the Komi-Permyakskii autonomous okrug. With clear backing from the presidential administration, this small, poor okrug was merged with a larger, wealthier and ethnically Russian oblast (Goode, 2004). The constitutional law on this unification was signed in March 2004. Thus, since January 1, 2005, the number of regions in Russia has been 88. The next planned merger involves the Ust-Orda Buriat autonomous okrug and the surrounding Irkutsk region. Referendums on the matter, originally set for December 2004, were postponed, however, due to disagreements on the terms of the merger.

Active discussion also surrounds the status of Khanty-Mansi (Yugra) and Yamalo-Nenets autonomous okrugs and their parent region Tyumen. In this case, the setup is more complicated as the autonomous okrugs are large and rich regions with titular finno-ugric minorities. Tyumen, in contrast, is a fairly poor agricultural region with climatic conditions much different from the northern autonomous okrugs. Also the discussions on merging Nenets autonomous okrug with Archangel as well as on merging Koriak autonomous okrug with Kamtchatka have been promoted – especially after the heads of the autonomous okrugs in question were changed in early 2005.

3.4 Post-Beslan reforms

A new set of radical measures to reform the federal-regional relations was announced by the president on September 13, 2004. The tragedy in Beslan increased demand for security, control and quick solutions. The situation is somewhat similar to the post-9/11 US in that Beslan created a window of opportunity for the government to launch far-reaching reforms to promote security and national unity. In a speech to the extended government (including governors), Putin announced two legislative initiatives and a presidential decree affecting inter-governmental relations by increasing central control over regions. The initiatives comprise elements discussed earlier; some of the material was evidently drafted beforehand. However, in the name of an anti-terrorist campaign, the administration was able to slip in several politically controversial initiatives that would have raised wide criticism in more peaceful times.

The first initiative, signed into a law in December 2004, abolishes gubernatorial elections. Governors now serve de facto at the will of the president. The president was also given the power to immediately dismiss any governor who no longer enjoyed his confidence. First to go was Vladimir Loginov, governor of Koriak autonomous okrug. Loginov was sacked in March 2005 following a crisis in heat deliveries in his region.

A closer look at way governors are now nominated closely resembles the new procedure for nominating the city managers for districts. This confirms the fact that the Kremlin apparently wants regional-local relations to mimic federal-regional relations in every respect. The first twelve governors will be nominated during 2005.[5] The second legislative initiative will abolish the single mandate districts from Duma elections. In the

[5] The latest gubernatorial election was held in Nenets AO in January 2005. Those awaiting nomination in early 2005 were Jewish AO, Saratov, Altai, Amur, Tula, Stravopol, Kaliningrad and Chelyabinsk.

future, all Duma deputies will be elected from country-wide party lists. It is hardly possible to see how these measures could, at least directly, increase security or prevent terrorism. The reforms will, however, clearly increase the Kremlin's power vis-à-vis governors.

There are several few aspects of the changes worth noting:

- It will be the president, not the government or the Duma, who names the gubernatorial candidate.
- Nominated governors will be loyal first and foremost to the president.
- As governors nominate half of the members of the Federal Council, the upper chamber will become a legislative body under the president's indirect control.
- "Independent" deputies elected from single-mandate districts used to be the favourites of the current governor. Now governors of small and poor regions will lose much of their ability to influence elections.
- With the abolition of single-mandate districts, Russia has moved closer to a two-party system. To be functional, however, such a system requires two relatively large parties. Present-day Russia has only one. Indeed, it is questionable if the current party of power, Unity, should even be treated as a true political party.

The third issue on federal relations is Putin's announcement of the creation of district and regional anti-terrorist commissions coordinating the work of local and regional bodies in fighting against terrorism and subversive activity. As it is impossible to say what the role of these commissions will be, in the aftermath of Beslan it is highly probable that the security organs will be given greater power over elected bodies. In Russia, as in several other countries, the security organs are de facto accountable only to the president.

Similar to the 2000 reforms, sceptics of the reform package were offered a token compensation. Fully aware of the fact that the announced reforms would cause concern about diminishing democracy, Putin ordered the formation of a public chamber. This chamber would have duties similar to parliaments in some western European countries,[6] but would lack any real power of its own. The initiative resembles the creation of the State Council, established in summer 2000. The State Council proved to be a governor's discussion club with no powers whatsoever and convening only when the president found it useful.

[6] "I would also like to stress that, if we are counting on society's help in the war against terrorists, people must be sure their opinions will be heard. In this connection, I support the idea of forming a public chamber as a platform for wide dialogue, where civic initiatives can be presented and discussed in detail. No less importantly, this chamber should become a place for conducting public examinations of key state decisions, and above all of draft laws that concern prospects for the country development of national significance." Putin's speech on September 13, 2004.

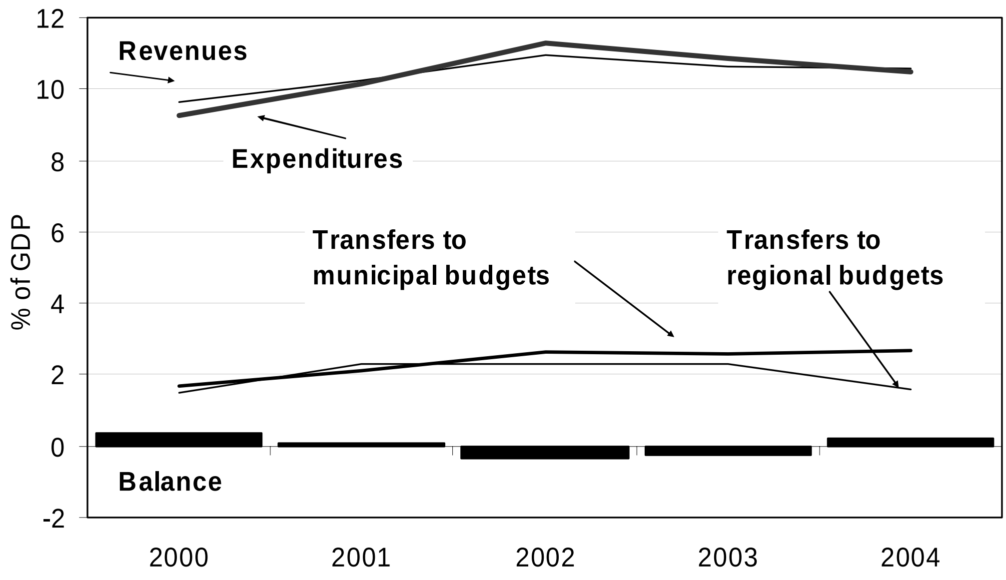
4 Putin's reforms – Changing fiscal federalist relations

During the 2000s, the reform of fiscal federalist relations has been a top priority in Russia. Many new laws and regulations have been passed in a short period of time, including amendments to the Budget Code, reforms in social security system and new tax rules. While some of the changes have just been introduced and others have yet to be put into force, the issue of whether a functional fiscal federalist system has been established remains unclear. There remain many practical questions to be solved before final judgement can be passed on the success of the reform in achieving its goals of increased transparency and clarity in budget relations as well as greater independence of regional and municipal budgets linked with the subsequent responsibilities.

Russian regions and municipalities jointly handle a wide variety of responsibilities; mainly those related to education, health care, housing and social policy. Despite the reforms, the division of tasks between these levels of administration is poorly documented and appear to vary widely. In the following discussion, we mainly consider regional budgets (for revenue and expenditure structures of various budget levels, see Table 1). Fiscal relations between the federal centre and regions in the Putin era are reviewed by concentrating on specific changes in the revenue and expenditure of regional budgets, the channels of federal support to regions and the debt policies of individual regions.

In recent years, regional budgets have generally been balanced, producing either tiny surpluses or small deficits (see Figure 2). As a share of GDP, revenues and expenditures grew from 2000 to 2002 and decreased slightly thereafter. The overall developments of regional as well as municipal budgets have not followed the lines of federal budget, the surplus of which has continuously increased in the 2000s.

Figure 2. Revenues, expenditures and transfers of regional budgets.



Source: Federal Statistics Service

Table 1. Revenue and expenditure structure of federal (FED), consolidated regional (CBR), regional (RB) and local (LB) budgets in 2004.

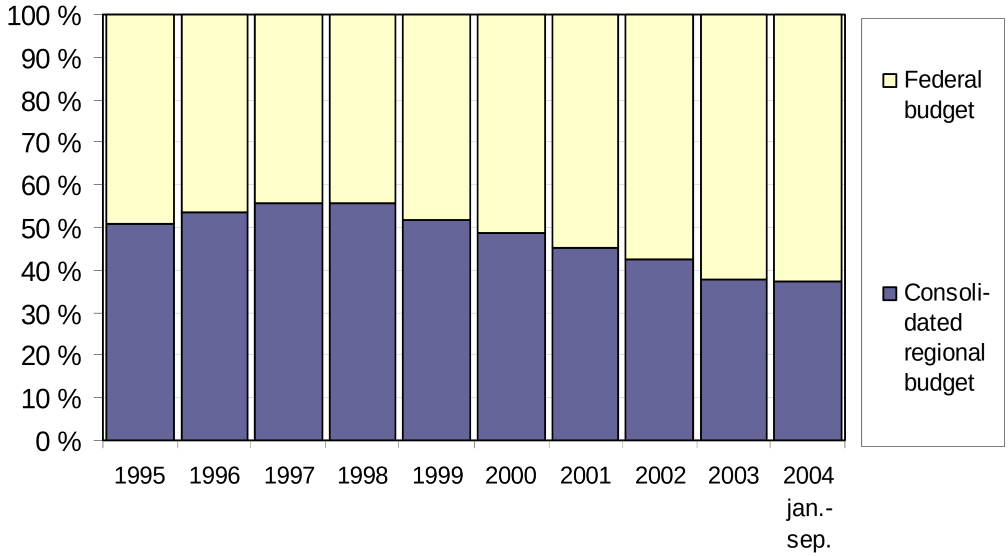
	2004 % total CRB	RB	LB		2004 % of total FED
Revenues	**100**	**100**	**100**	**Revenues**	**100**
Tax revenues	62	68	52	Tax revenues	79
Of which				of which	
* Profit tax	23	27	17	* VAT	31
* Income tax	20	19	21	* Customs duties	25
* Property taxes	5	5	5	* Resource payments	13
* Resource payments	5	6	3	* Profit tax	6
* Excises	4	6	1	* Excises	3
* Local taxes and payments	1	0	1	* Other taxes	1
* Regional taxes and payments	1	1	0	Non-tax revenues	6
* Other taxes	3	3	3	of which	
Transfers	8	15	40	* Revenues from state property	5
Budgetary funds	6	9	0	Transfers from other budgets	1
Revenues from property	6	6	5	Unified social tax	13
Other revenues	19	2	3	Other revenues	1
Expenditures	**100**	**100**	**100**	**Expenditures**	**100**
Housing and comm. services	10	5	19	Transfers to other budgets	34
Education	17	7	33	of which	
Health care	11	10	14	* Federal support to regions	15
Industry, energy, construction	10	13	8	* Unified social tax	16
Social policy	9	9	8	Defence	16
Administration	5	4	7	Social policy and culture	13
Transportation, communications	2	2	1	Security	12
Agriculture, fisheries	2	2	1	Interest payments on debt	8
Security and law	2	3	1	Administration	3
Culture, arts, cinema	2	1	3	Industry, energy, construction	3
Roads	1	2	1	Other expenditures	11
Interest payments on debt	1	1	0		
Transfers to other budget levels	1	26	0		
Budgetary funds	6	10	0		
Other expenditures	21	6	3		

Source: Compiled from Ministry of Finance information

4.1 Regional budget revenues

The increasing power of the federal centre during 2000s is apparent in many fiscal issues. As a share of consolidated budget revenues, regions now receive much less than in the mid-1990s (see Figure 3). Moreover, the ongoing tax reform has brought about many changes that have decreased the number of taxes regions may decide upon and changed the distribution of shared taxes between these administration levels. On the other hand, overall good economic performance has eliminated regional budget deficits, and in some years, even produced modest budget surpluses.

Figure 3. The shares of federal and consolidated regional (including municipalities, before transfers) budgets in total consolidated revenues.



Source: Federal Statistics Service

A notable change during the period 2000–2004 was the strong growth of tax revenues. However, these revenues were almost solely derived from federally imposed taxes, mainly higher revenues from profit and income taxes. (For the situation in 2005, see Table 2.) In 2000–2001, the *profit tax* rate was still 35 % and regions kept half to two-thirds of the revenues accrued from it. Since the tax rate was cut to 24 % in 2002, regions have each year received a larger share. In 2005, the share going to regions is 80 %. Improved enterprise profitability has also contributed to growth in recent years.

Higher *income tax* collections reflect growing real incomes in the 2000s and the changing division of income tax revenues between the federal centre and regions. During 2001–2004, nearly all income tax revenues went to regional budgets, whereas in 2000 and before 1997, the federal budget received a varying share.

Table 2. Taxes and fees in Russia in 2005.

Tax/fee	Level that imposes the tax	Determines the tax base	Determines the tax rate	Receives the tax revenues
1. VAT	**federal**	**federal**	**federal**	**federal 100%**
2. Excises	**federal**	**federal**	**federal**	**federal**, regional
3. Profit tax	**federal**	**federal**	**federal***	**federal**, regional
4. Income tax	**federal**	**federal**	**federal**	regional, local
5. Unified social tax	**federal**	**federal**	**federal**	**federal** + federal and territorial social funds
6. Taxes and payments on the use of natural resources	**federal**	**federal**	**federal**	**federal**, regional
7. Water tax	**federal**	**federal**	**federal**	**federal 100%**
8. Payment on the use of wild animals and biological water resources	**federal**	**federal**	**federal**	**federal**, regional
9. State fees	**federal**	**federal**	**federal**	**federal**, regional, local
10. Inheritance and gift tax	**federal**	**federal**	**federal**	regional 100%
11. Enterprise property tax	regional	**federal**	regional**	regional 100%
12. Gambling tax	regional	**federal**	regional**	regional 100%
13. Transport tax	regional	**federal**	regional**	regional 100%
14. Land tax	regional	**federal**	regional and local***	local 100%
15. Tax on property of physical persons	regional	**federal**	local****	regional 100%

* federal centre determines the rate and the upper level of the tax in regions

** regionalities determine the rate within the federally set limits

*** tax base is determined from the average tax rate set by law

**** localities determine the rate within federally set limits

Source: Compiled from information from the Center for Fiscal Policy

Increases in profit and income taxes have been counterbalanced by changes that work to diminish regional revenues. *Transfers from federal budget* remained quite steady in 2001–2003, but then were cut sharply last year to the 2000 level of about 1.5 % of GDP. Transfers presently account for about 15 % of regional revenues, down from over 20 % in previous years. In net terms, transfers to regions have been negative since 2002. In other words, regions receive less money than they are obliged to pass along. Concurrent with this development, localities have become more dependent on transfers from above.

In relation to GDP, revenues to *budgetary funds*[7] have also fallen by half during the 2000s. It is difficult to say whether this is more an indication of a tendency to get rid of these funds or a possible redirecting of resources to unofficial funds. The resources of a budget fund cannot be used for other purposes than that for which it was created. Due to ineffectiveness and oversight problems, there has been a tendency to reduce the number of these funds in federal budget in recent years.

The decision to leave all *VAT* revenues to federal budget has profoundly affected regional budgets. As recently as 2000, VAT revenues accounted for about 8 % of total regional revenues. The elimination of the sales tax from the beginning of 2004 also cut regional revenues. Previously, the sales tax accounted for 3 % of total regional revenues.

The question on whether to centralise all revenues from natural resources is crucial for a country with substantial, but highly dispersed, natural resources. Perhaps surprisingly, *resource payments* have recently stayed quite stable at the regional level. Nearly all of the benefit from recent rises in world commodity prices has gone to the federal budget. During the 2000s, natural resource payments have accounted for about 5–7 % of total regional revenues; in relation to GDP, their share has been 0.5–0.8 %. Thus, it seems that regions as a whole have been able to enjoy an exceptionally favourable world market situation only indirectly. State revenues from high oil and gas prices have mostly been directed to the federal budget or the stabilisation fund.

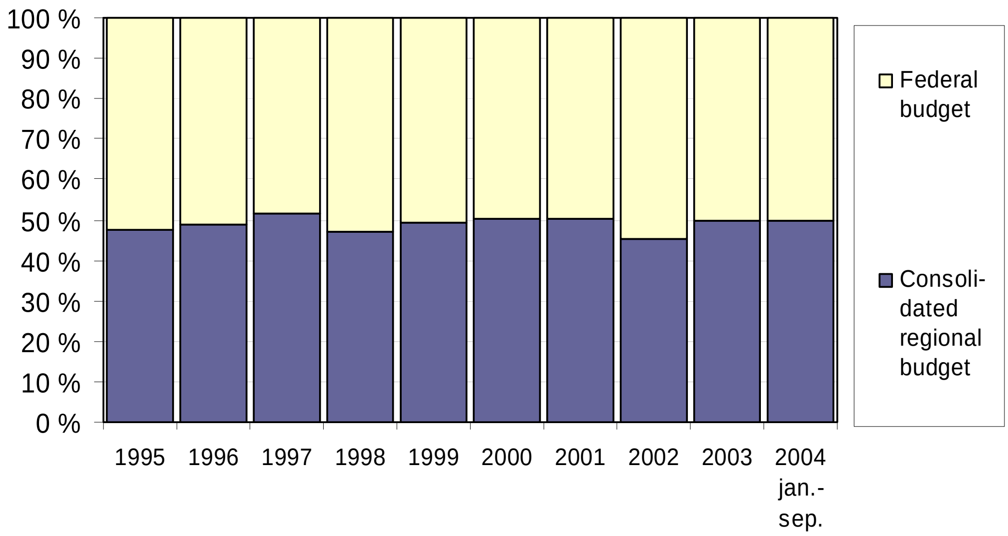
As regards individual regions, the picture is somewhat blurred since regions differ in their natural resource endowments. However, even among the richest regions the impact of rising world market prices has been highly inconsistent. Some rich regions have seen the payments from natural resources as a share of their total revenues increase markedly (Khanty-Mansi and Yamalo-Nenets autonomous okrugs), others have seen them remain stable (Republic of Tatarstan), and some have witnessed a decline (Tyumen oblast). One reason for this is that legislation previously treated revenues from taxes on oil and gas extraction differently depending on whether they originated from autonomous districts, krais, oblasts or other federal jurisdictions (shares varied from 5 % to about 14 %). The regulations were amended this year. In the case of gas, the federal budget receives 100 % of the resource tax, whereas in case of oil it gets 95 %. Thus, all regions, regardless of status, now get a mere 5 % slice of the tax on oil extraction.

[7] Regionalities have the right to establish budget funds under the decision of regional parliaments. Most regional budget funds are road funds.

4.2 Regional budget expenditures

In contrast to revenues, which have gradually shifted to the federal centre, the 50-50 split on expenditures persists (Figure 4). Some 75 % of regional spending falls into three blocks: transfers, social and educational expenditures, and expenditures related to industry, agriculture and transportation. The main expenditure item for years has been *transfers to other budgets*, which in practice means transfers to localities. Compared to 2000, transfers both as a share of total regional expenditures and as a share of GDP have increased. In 2004, about a quarter of regional expenditures were transfers to other (local) budgets, which means that localities are highly dependent on transfers from regions. In 2000, local budgets received slightly under 30 % of their revenues in the form of transfers; in 2004, the share was 40 %.

Figure 4. The shares of federal and consolidated regional budgets in total consolidated expenditures.



Source: Federal Statistics Service

While expenditures on *education and health care* have remained quite steady during 2000–2004, spending on *housing and communal services* has fallen by half as a share of GDP, indicating progress in transferring the burden of housing costs to the general populace.[8] At the same time, social spending has almost doubled. This change reflects the fact that part of housing subsidies are now paid as social support, which is a positive move to the extent that housing support is now more reliably secured for the neediest members of Russian society. In the Soviet era, all Russians were equally entitled to such support (at least in theory), independent of their incomes. Construction-related spending has exploded in recent years, while support to agriculture has been halved in relation to GDP.

[8] In local budgets, too, expenditures on housing and communal services as a share of GDP have decreased markedly.

4.3 Federal support to regions[9]

It is necessary to distiguish here between official and unofficial financial flows between the federal centre and regions. Official flows are transferred through the budget, while unofficial flows are transferred using large variety of mechanisms. What might be termed "quasi-official" financial flows also exist. As unofficial and quasi-official flows are hard to measure, estimates of the actual federal support to regions vary. In 1995–1998, the total (official and unofficial) federal support to sub-nationalities was estimated to hover around 1.5–3 % of GDP. It was assessed to have diminished to 1–1.5 % of GDP in 1999–2000.[10]

Official support to regions

Official financial support to regions comes mainly in the form of "donations" (*dotatsii)*, budget funds delivered on a non-compensable, gratuitous basis for current expenditures. In 2003, their share was nearly 60 %. Less than 30 % of regional financial support in 2003 was given on a non-compensable, gratuitous basis for certain pre-determined expenditures *(subventsii)*, while some 10 % of support was designated for financing pre-determined expenditures jointly *(subsidii)*.

Since the start of the 2000s, official federal support to regions has been channelled through five funds with different roles and weights as providers of support. The oldest and most important of the funds is the *Fund for Financial Support of Subjects of the Russian Federation* (Russian abbreviation *FFPR*) established in 1994. FFPR support is given to regions mainly in the form of donations. The other four funds were established during the Putin administration, which means they have only operated a few years. It is probably premature to attempt an evaluation of their usefulness and effectivness.

The rules for providing FFPR support have changed radically over the years. In its early days, the support system did not encourage regions to increase tax collection and cut expenditures. Nowadays a combined methodology is used. It is based on parameters that take into account the average revenue level in regions, the tax potential of the region and the average regional spending on producing budgetary services. Despite the reforms, the comparison of both budget revenues and expenditures per inhabitant in Russian regions in 2000 and 2003 shows no change as regards the difference between the poorest and richest regions. In both 2000 and 2003, the revenues and expenditures of poorest regions were less than 4 % of those of the richest.[11]

The *compensation fund* was established to secure implementation of some of the largest "unfunded mandates of regions,"[12] costly tasks delegated to regions by federal laws without guarantees of the requisite financing. The majority of unfunded mandates are related to social services for certain beneficiary groups such as war veterans. Most regions cannot afford to offer their citizens all the services delegated to them by federal centre. What is offered varies greatly among regions. From the beginning of 2005, as a part of the general budgetary reform, it was agreed that the principles on the division of social responsibilities and their financing needed clarification. Many regional authorities,

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[9] The chapter is based on information from Klimanov & Lavrov (2004), 111-125 and Solanko & Tekoniemi (2002), 12-13.

[10] OECD (2000), 134; Institute for the Economy in Transition (2001), 96.

[11] Sazonov (2004), 7-11.

[12] Specifically, child allowances and invalid benefits.

however, doubt that the practical implementation of the new laws will come about without new financial headaches and hierarchical conflicts.

The *fund for regional development* offers resources for federal programs at the regional level. In 2002–2004, the principles of the fund were reformed and the number of federal programs was diminished from several dozen to seven in 2003 and 2004. At the same time, the amount of resources distributed was increased. From 2005, the fund also distributes subsidies for road maintenance.

Other funds offering financial support to regions are tiny and highly specialised. The *fund for financing social expenditures* secures the implementation of certain priority social expenditures jointly with regions. Initially, the resources of the fund were meant to be used for housing subsidies, but later it was decided to use them also for salary increases of civil servants. The *fund for reforming regional finances* has delivered financing for budgetary reforms in regions on a competitive basis using World Bank loans. However, the fund was abolished in the end of 2004 and replaced by *the fund for reforming regional and municipal finances*, which will distribute resources on a competitive basis to a wider group of recipients.

Table 3. Federal funds for regional support.

Federal funds for regional support in Russia	
	Established
1. Fund for financial support of federal subjects	1994
2. Compensation fund	2001
3. Fund for financing social expenditures	2002
4. Fund for regional development	2000
5. Fund for reforming regional finances	2001*
6. Fund for reforming regional and municipal finances	2005**

* was eliminated in the end of 2004
** was established in 2005

Unofficial support to regions

The informal channels of federal support take variety of forms of mutual settlements, i.e. transfers to regions not subject to official budgetary regulation.[13] They are usually a result of bargaining and negotiating between the centre and individual regions. At the beginning of 2000s, they were estimated to account for as much as a fifth of total federal support to regions. In the case of mutual settlements, both central and regional officials are involved with informal measures. Even so, the easiest way for regions to enhance their fiscal position is through cooperation with regional enterprises. As during the Soviet era, ties between regional administration and enterprises remain tight. Enterprises are accustomed to receiving tax allowances and other forms of special treatment in return for their involvement in building and maintaining regional infrastructure or providing social services. Off-budgetary funds and regional accounts also serve as a way to hide resources from the federal budget.

[13] OECD (2000), 135.

It is difficult to estimate whether the importance of informal federal aid and the arrangements regions use to finance their own activities has changed in recent years. The reform of fiscal relations aims at increasing transparency and setting forth fair, clear rules for federal support. Thus, the role of informal fiscal measures in both centre-region relations and intra-regional relations is expected to diminish.

4.4 Regional debt policies

Regional and local borrowing experienced a steady growth before the 1998 financial crisis. The increasing willingness to take on debt was driven in part by budget deficits that resulted from attempts to meet at least the most important federal mandates, budgetary wages and subsidies, and, on the other hand, from hiding revenues from federal centre. Another factor may have been the incapability of regional administrations to implement reforms that would have made their functioning more efficient, including cutting costs in less important functions in favour of the more important tasks. Nevertheless, it is self-evident that a major reason behind growing regional debt was the fact that sub-national administrations took for granted that the centre would bail them out if they ever encountered debt repayment problems.[14]

Since the financial crisis of 1998, regions and municipalities have gradually returned to the bond markets. Standard & Poor’s currently rates 17 regions and a couple of municipalities, while Moody’s rates 15 regions and cities.[15] Sub-federal bonds account for some 14 % of the national bond market ($4.2 billion in October 2004, or less than 0.1 % of GDP). In comparison, sub-national domestic and foreign debt at the start of 1999 was roughly estimated at slightly over 7 % of GDP. About third of regions have issued their own bonds. Average indebtedness is still low as a share of regional budget revenues (7 % of the expected regional budget revenues in 2004), although the situation varies considerably among individual regions.[16] Ministry of Finance figures for end-September 2004 indicate that regional debt as a share of total revenues of various regions (without transfers) varied between 5 % and 179 %.[17]

The federal centre extends budget loans to regions experiencing problems in balancing their budgets. *Soft budget constraints* have not been totally eliminated; the central government keeps prolonging and writing off these non-performing loans. In some regions, the practice has been abused by directing revenues to off-budget funds that allow part of the revenues to be used secretly. False revenue figures are then reported to the federal authorities.[18] Under the amended Budget Code, which entered into force at the start of 2005, budget loans will now be given only for a year at an interest rate mentioned in the budget in question.[19] If the loans are not paid off in a timely manner, they will be covered with resources from the FFPR and/or with the regional share of federal taxes or payments meant for the region in question.

[14] OECD (2000), 143–144.

[15] Moody’s Europe (2004), 7.

[16] OECD (2000), 145-146, Standard & Poor’s (2004).

[17] Minfin (2004).

[18] Standard & Poor’s (2004), 4.

[19] Under the 2005 budget, budget loans for temporary needs are granted at an interest rate that is one-fourth of the Central Bank of Russia’s refinancing rate (on Jan. 1, 2005, for example, it was 13 %). Loans for major accidents or catastrophes carry an interest rate of 0%.

5 Conclusions

Russia is the world's largest country in terms of land area, so it is perhaps inevitable that that administering this vast territory is problematic. The traditional set of solutions before and during the Soviet era always included centralised control and vertical lines of command. Thus, developments in the 1990s would seem to represent a clear departure from the rule.[20] During the past four years, however, the ascendant policy is to curb the power of the independent-minded governors, unify fiscal rules, streamline chains of command and restore the supremacy of the federal centre and its security organs above all other power bases.

This observation is not meant to refute the many examples of positive development. Reforming the jungle of unequal and asymmetric fiscal federalist relations has been rightly seen as a prerequisite for balanced fiscal policy and prolonged economic growth. Measures such as abolishing many of the smaller local and regional taxes (often imposed for dubious reasons) are clearly a victory for promoting the growth of new businesses. A more permanent basis for allocation of tax revenues among administrative levels helps fiscal planning. Favourable macroeconomic conditions and an immensely popular president have also made these reforms relatively easy to push through. Finally, Russia should be lauded for retaining fiscal discipline in the face of high world prices for oil and other commodities.

On the other hand, there is darker side to these positive developments. The recent trend aiming to expand the federal power has increased concerns about the precise meaning of the government's intentions of "restoring of law and order." Russia's bureaucratic culture is prone to going overboard with change. Thus, reliance on the orders from above easily translates into an atmosphere where private initiatives or new innovations are discouraged. Indeed, the entire administration may sometimes find itself paralysed in the absence of direct orders from the very top. Such a brutal consolidation of central power would inevitably inhibit economic growth and progress in structural reforms.

The fiscal federalist system needs to be designed to make individuals and sub-national administrative units feel that they are contributing to the common good, while accurately reflecting local and regional preferences *(political responsibility)*. The system should also be fair in its treatment of different individuals and regions. In theory at least, both these features are reflected in the reform of fiscal federalist relations in Russia. In practice, regions, municipalities and individuals are still highly sceptical and must rely to some extent on their own informal channels for financing. Recent changes to social security system having direct implications for regional and local budgets represent a typical example on the planning and implementation of reforms in present-day Russia. The wave of protests against social services reforms tell either about poorly planned reforms or mistakes in their implementation.

In its current condition, one could even ask if Russia really is a federation at all. Russian federalism is certainly quite different from the generally accepted definitions of federalism which stress not only clear division of labour between regions and the centre but also the autonomy of the regions that constitute the federation. A federation where regions have no open, democratic and constitutional representation in a federal legislative body is a wretched orphan in the family of nations.

[20] The only other exceptions of which we are aware of are the original Time of Troubles (*smutnoye vremya*) in the early 17th century and the status of the Grand Duchy of Finland in 1809–1899.

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