Russian Federation: Development of Public Finances and Subnational Debt Markets

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Introduction

Since the formation of the modern Russian state in 1991, the development of the subnational debt market in the Russian Federation has gone through three distinct phases: the 1990s, 2000–08, and 2008 onward. How and why subnational governments (SNGs) accessed the financial markets throughout the three phases has been substantially shaped by the evolving macroeconomic conditions in Russia and the development of an intergovernmental fiscal system since 1991.

During the first phase, the 1990s, the system of intergovernmental relations was highly centralized. The central government controlled subnational spending standards and norms, set prices for housing and utilities services, regulated wages of government employees, and arbitrarily determined the shared taxes assigned to each region. Intergovernmental fiscal transfers were negotiated between the federal Ministry of Finance and regional governments. During this period, Russia went through an unstable and uncertain macroeconomic situation in the early 1990s, followed by stabilization from 1992 to 1997. But the high fiscal deficit of the federal government and extensive use of internal and external borrowing to cover budget deficits contributed to the
accumulation of federal government debt. This was followed by growing federal debt, financial crisis, and federal default on debt obligations in the late 1990s.

It is within this context in the 1990s that the subnational debt market began its early development and reached its peak in capital market development in 1997, and was then followed by defaults by most regional governments during 1998–2000. The growing demand on SNGs, unfunded federal mandates, and political decentralization contributed to the growing demand for debt instruments by SNGs. At the same time, there was a complete lack of debt regulation, and SNGs contracted debt through informal negotiations with the federal government. SNGs also lacked experience and capacity in managing debt risks. Debt was issued to finance recurrent expenditures, mostly with short-term maturities. With a rapidly deteriorating macroeconomic environment in Russia in the late 1990s, refinancing risks facing SNGs rapidly rose, and the federal government, with its own macroeconomic woes, was not in a position to provide support to SNGs. Fifty-seven of 89 regions defaulted on their debt from 1998 to 2000.

The subnational debt market entered its second period of development in 2000, and its development up to 2008 was helped by macroeconomic stabilization and success in Russia. Improved macroeconomic fundamentals contributed to positive changes in intergovernmental relations and incentives for new principles of financial management for the regions and municipalities. Gradually, financial capabilities of the Russian regions began to improve. Substantial legislative reforms—significant amendments to the Tax Code and the adoption of the Budget Code—were undertaken, aimed at the creation of a new formula-based system of relations among the tiers of government to replace the outdated, nontransparent, and informal arrangements. The 2006 legislation on local self-government established a uniform two-tier system of local self-government. Since the second half of the 2000s, the federal government has been paying more attention to the quality of public finance management in the regions and municipalities, which, in the long term, underpins the access by SNGs to market-based financing.

The Budget Code regulates subnational debt. Specifically, it specifies (a) sources for budget deficit financing; (b) limits on the size of fiscal...
deficit, debt, and debt service; (c) regulations on external borrowing and on guarantees; and (d) sources of deficit financing and structure and types of debt instruments. In addition, the Budget Code, and especially the 2007 amendments, regulates the system of granting federal, regional, and municipal guarantees. The Budget Code also establishes the structure of regional and municipal debt, its types, and maturity. Favorable terms of international trade and successful domestic economic development in Russia, especially between 2004 and 2008, have largely neutralized some negative aspects of the reform of intergovernmental fiscal relations for some of the Russian regions and municipalities. Their financial positions have strengthened considerably, together with revenue growth.

The debt load of the Russian regions remained low at the end of 2007. The regional debt was unevenly distributed across regions; five large regions accounted for about half of regional debt. Another feature of the debt of Russian regions was its short-term character. Short-term bank loans were a major debt instrument for most Russian regions. The majority of SNGs had little experience in debt management and had only short credit histories. During 2000–08, regions and municipalities showed increasing interest in obtaining credit ratings from rating agencies. Access to capital markets, however, is limited to the most creditworthy SNGs.

The global financial crisis of 2008–09 severely struck Russian public finances in 2009, though the impact varied across regions and municipalities. The strong regions that relied on their own tax capacity or exports were among the most severely affected, while the regions with a greater dependence on federal transfers appeared to be less affected. Bank loans and federal government loans became the main debt instruments of SNGs. The major problem for the Russian regions was not the absolute size of a debt load, but its payment structure. Reduced debt maturity terms created a substantial risk for refinancing and high debt service costs—factors that put pressure on their budgets.

A key difference between the 1998 and 2008–09 crises was the lack of defaults of regions on their debt obligations during the latter, owing to additional support from the federal government and the liquidity accumulated during previous years by the regions. Nonmarket instruments for financing the deficit of subnational budgets predominated in 2010.
Since 2011, subnational fiscal positions have improved, and the Russian economy has gradually recovered. The debt markets have recovered, and borrowing costs have been reduced. But activity in the domestic bond market remained moderate until 2011, when the market expanded. The debt repayment profile continued to be short due to the large share of short-term bank loans in the debt structure.

This chapter analyzes the development of the subnational debt market in Russia over the last 20 years, and shows how subnational debt market development is influenced and shaped by key macroeconomic developments and the evolving structure of the intergovernmental fiscal system. The chapter is organized as follows: section two describes the development of the subnational bond market from birth to expansion and from crisis to recovery over the 10-year period, 1991–2000. Section three summarizes key reforms in the intergovernmental fiscal system from 2000 to 2008 and how they have shaped the regulatory framework for subnational debt borrowing. Section four discusses the impact of the 2008–09 global financial crisis on subnational fiscal performance and subnational access to borrowing. Section five concludes with remarks on the challenges to the continuing development of the subnational debt market in Russia.

The Subnational Bond Market in Russia: Birth, Expansion, Crisis, and Recovery, 1991–2000

The formation of the modern Russian state began in 1991. The new state inherited its federal structure from the Soviet Union. The current structure of the government includes (a) the federal government, (b) 83 regions, (c) self-governments of the first-tier municipalities (520 larger cities and 1,793 rural districts), and (d) self-governments of the second-tier municipalities (1,732 townships and 19,919 rural communities).¹ In the 1990s, the system of intergovernmental relations was highly centralized. The central government controlled subnational spending standards and norms, set prices for housing and utilities services, and regulated wages of government employees. The shared taxes assigned to each region were arbitrarily determined by the central government. Intergovernmental fiscal transfers were negotiated between the federal Ministry of Finance and regional governments.
Russia faced an unstable and uncertain macroeconomic situation in the early 1990s, and the Russian government undertook a series of steps to stabilize the economy. The steps included (a) the creation of the federal treasury payment system, (b) phasing out of monetary financing to cover federal spending, (c) reducing wage and other spending arrears in the government sector, (d) liberalization of exchange rate regulation, (e) setting substantial foreign currency reserves, and (f) curbing inflation. However, the annual deficits of the federal government in the second half of the 1990s reached 7–10 percent of gross domestic product (GDP). Consequently, the government made extensive use of internal and external borrowing to cover budget deficits, which contributed to the accumulation of debt. In addition, nonfinancial instruments—barters and offsets—were heavily used.

Russian regions and municipalities also faced difficulties. The budgeted deficit was rather high in each region, and in many regions it reached 50 percent of revenues, including transfers, while revenue collection was low and unstable. Regions and municipalities actively resorted to short-term borrowing to finance their expenditures. In the mid-1990s, bank loans and bond issues became popular. At the same time, regulation of the subnational debt markets was erratic and under political influence. There were no restrictions on the amount of borrowing or the purpose of borrowed funds.

In practice, regions and municipalities borrowed mainly for current expenditures, on disadvantageous terms. They did not develop payment or debt refinancing plans. As a result, subnational entities had accumulated a significant amount of short-term debt between 1993 and 1996. In addition, in the 1990s, the Russian regions relied heavily on such unconventional short-term debt instruments as accumulation of budgetary overdue payables. In 1998, budget payables of SNGs amounted to 15.3 percent of subnational spending, or 4.7 percent of GDP. The budgetary payables, however, were nearly fully offset by overdue taxes to SNGs, thus creating the mechanism of noncash spending.2

**Development of Regional and Municipal Bond Markets in the 1990s**

During 1992–93, the bond issuance process was experimental in nature. The first bond was issued by the regional government of Khabarovsk
Krai in March 1992. The Ministry of Finance registered only five bond issues by regions and municipalities in 1992 and eight in 1993. Bonds were placed and circulated on isolated regional markets with inadequate bond market infrastructure. A clear legal framework did not exist, investors demonstrated weak interest, and market infrastructure was lacking.

From 1994 until the macroeconomic crisis in the late 1990s, regions and municipalities became more active in using bond instruments as an alternative to bank financing. The Ministry of Finance registered 28 issues of regional and municipal bonds in 1994 and 73 in 1995. In 1995 and 1996, some regions used bonds to finance 50 percent of their budget deficit. Regional and municipal bills became more popular (as a convenient instrument for which registration was not required); they were used by the authorities to untie the knot of nonpayments and finance budget expenditures. However, after enactment of the law “On the Promissory Note and the Bill of Exchange” in 1996, the government banned issuance of guarantee bills. As a result, they were replaced by regional and municipal bonds, whose issues had increased dramatically. The peak was registered in 1997, with 313 issues of regional and municipal bonds worth 29.5 billion rubles (almost US$5 billion). Hyperinflation and the lack of a regulatory framework were the main challenges to the development of the subnational bond market at that time.

In 1996, Russian SNGs for the first time entered the external market for borrowing. The regional governments of Moscow and St. Petersburg issued Eurobonds. Borrowing in a foreign currency was motivated by significantly more attractive borrowing terms (lower rates, longer terms of loans, large amounts of borrowing); SNGs assumed that these terms would continue given the then fixed exchange rate system (the fixed exchange rate was abandoned in the late 1990s macroeconomic crisis).

During 1992–96, the Russian subnational bond market demonstrated the following features:

- Issuers (Russian regions and municipalities) did not provide prospectuses, including the purpose of borrowing, of acceptable quality. Therefore, market participants had no reliable information on the financial and economic status of a jurisdiction. The bulk of the funds received from the bond issue was used to cover temporary cash gaps or simply to increase revenues.
• When issuers selected agents for placing and maintaining bond proceeds, most of them gave strong preference to local financial institutions, which were small and unreliable. Thus, strong investors, facing high risks dealing with regions and municipalities, refused to enter the regional market.
• No generally accepted and guaranteed payment mechanisms existed for issued bonds. Often, debt service costs were not shown as a separate line item in regional and local budgets.
• A significant portion of bonds was used as a barter instrument for tax payments to the regional budget, which only increased the flow of real financial resources out of a region.

By 1997, the macroeconomic situation in Russia had improved: GDP began to show positive growth, and inflation and interest rates declined. Foreign capital flows increased into the sovereign debt market in response to the reduction of political risk after the 1996 presidential elections and the progressive external financial liberalization. In general, the attitude of domestic and foreign investors to Russian debt securities improved—for the first time since credit ratings were assigned to them.\(^7\)

The activity of regional and municipal authorities in the debt securities market reached its peak in 1997, with the city of Moscow the largest and most active borrower. The total number of registered issuances of regional and municipal bonds increased more than eightfold from 1996 to 1997 (from 39 to 313). On January 1, 1998, the Ministry of Finance of the Russian Federation registered 446 issues, totaling an equivalent of US$8.3 million. About 70 percent of the total number of bond issuances during 1992–97 was registered in 1997.\(^8\) One of the features of the regional and municipal bond market in 1997 was again that a significant portion of issuances had no particular purpose. Most of the bonds (60 percent) were short or medium term. Conditions in the securities market worsened by the end of 1997; interest rates began to rise and became unstable, while the maturity of bonds slightly increased. As a result, the pressure on regional and municipal budgets increased (figure 12.1), making debt policy planning more difficult.

Despite this, regions and municipalities continued to issue securities until May 1998. From January to May 1998, the Ministry of Finance registered 59 bond issues. However, the average monthly value of bond
The macroeconomic crisis in Russia in 1998 was triggered by both external and internal factors. The global economic slowdown that began in 1997 was responsible for the decline in world demand for oil, which had a negative impact on the Russian federal budget. Internal factors—weak monetary and fiscal policy, a fixed exchange rate, excessive government borrowing—also contributed to the crisis in August 1998. The federal government defaulted on virtually all domestic obligations and was forced to cancel the fixed exchange rate. The crisis led to a sharp devaluation of the ruble, a fall in real GDP by 5.3 percent, a jump in annual inflation to 84 percent, and the collapse of the banking system.\(^9\)

From June to August 1998, 28 regional and municipal governments continued issuing their bonds, though the capacity of the Russian financial market was falling dramatically as a result of an abrupt outflow of foreign capital from Russia and a withdrawal of resources from the
securities market by nonresident investors, followed by conversion of these resources into hard currency. During June–August 1998, the first defaults of regions and municipalities on their bonds were reported. However, the cause of the defaults was not only the worsened financial situation but also the reluctance of issuers to pay their obligations.  

The majority of borrowing in the precrisis era was short term and was used to finance the current budget deficit; only a small part of borrowing was to finance capital investments. Regional governments were more active in the bond market than municipalities. Before 1998, only a few subnational entities had obtained credit ratings from international rating agencies. The regional governments of Moscow and St. Petersburg managed to get ratings from several international agencies. In that period, issuers operating in the domestic debt market got ratings to improve their image and demonstrate their openness to the investor community. However, credit ratings had almost no effect on the amount and cost of borrowing. At the same time, it was essential for the regions wishing to access foreign debt markets to obtain credit ratings from international agencies. Prior to 1998, there were only three regional governments that borrowed in the foreign debt market—the cities of Moscow and St. Petersburg and Nizhny Novgorod Oblast.

Despite the rapid development of the regional and municipal bond market in the 1990s, its share was only a small part in the overall Russian securities market. In 1997, bonds issued by regions and municipalities accounted for only 6.6 percent of the total bond market in Russia. The growth of Russian Government Treasury Bills and Federal Loan Bonds was rapid, and new types of government securities were emerging, targeting small and individual investors. But the institution of underwriting had yet to be formed for both the federal government and SNGs.


The events of 1998 demonstrated the risks of an unregulated debt market. External borrowing was attractive at a fixed exchange rate, but the devaluation significantly increased the debt load of SNGs that borrowed in foreign currency. Even those regions that relied solely on domestic borrowing could not avoid default, since they had not received expected transfers and shared taxes from the federal government, whose situation was also grave. Between 1998 and 2001, 57 of 89 Russian regions...
declared default on their debts. In fact, only the federal cities—Moscow and St. Petersburg—continued to make payments on their debt obligations. Figure 12.2 summarizes defaults by type of debt instrument.

A considerable share of these defaults was related to nonpayment on so-called agrobonds (as part of subnational bonds in figure 12.2). In the mid-1990s, many Russian regions received financial assistance from the central government for their agricultural sector. However, later the central government decided to convert this assistance into bonds. Many Russian regions considered this to be unfair and refused to repay after the 1998 crisis. At that time, the credit culture in Russia was relatively weak. For example, a newly elected governor or mayor could question debts raised by previous administrations.

The subnational defaults offer the following lessons: (a) borrowing in a foreign currency in the absence of reliable hedging instruments in an unstable macroeconomic environment is extremely risky, (b) unfettered market access by subnational borrowers can outpace the development of sound revenue systems and adequate security, and (c) it is essential to create a regulatory system for regional and municipal borrowing and debt market development (Alam, Titov, and Peterson 2004).

Figure 12.2 Subnational Defaults by Type of Debt Operation

The economy began to recover in 1999. Real GDP grew by 6.4 percent in 1999 after falling by more than 50 percent during 1991–98. While inflation peaked at 84 percent in the postcrisis year of 1999, it fell to below 20 percent in 2001. Foreign currency reserves grew from US$12 billion in 1998 to US$37 billion by the end of 2001. Several factors contributed to the strengthening of the Russian economy and the competitive position of the country in the world market, including devaluation of the ruble, subsidized domestic energy prices, and rising world prices of oil and gas. These strengthened the export sector, which remained stable.

Fiscal performance also improved with increased tax revenues and restricted expenditure growth. In 2000, the first federal budget surplus of 1.2 percent of GDP was recorded. In 2001, the surplus rose to 2.4 percent of GDP. The ratio of public debt to GDP decreased dramatically—to 43 percent in 2001 from 145 percent in 1998 due to the strengthening of the ruble, inflation effects, partial debt payment, and a write-off of US$10.6 billion in debt under a London Club debt restructuring agreement. Eventually, starting in 2000, Russian regions and municipalities began to restore their solvency. Assets of regional and local governments grew rapidly. According to the Central Bank of Russia, on November 1, 2001, bank deposits of regions and municipalities amounted in US$1.8 billion equivalent, while their liabilities to the banking system were US$730 million equivalent. Arrears of the regions also decreased significantly. During 1998–2000, increased financial resources were mainly used to refinance existing debt rather than to accumulate new debt. At the same time, by 2001 the surplus of regional budgets had reduced the subnational securities market by more than US$170 million equivalent. Changes in debt structure in favor of bank loans had also contributed to this reduction (figure 12.1). Nevertheless, despite the decline in the bond market as a whole, new subnational borrowers entered the market, while interest rates gradually returned to precrisis levels.

**Public Finance Reform, Debt Regulations, and Subnational Bond Market Development, 2000–08**

Improved macroeconomic fundamentals in the postcrisis period contributed to positive changes in intergovernmental relations and incentives for
new principles of financial management for the regions and municipalities. New legislative and administrative initiatives aimed at the creation of a new formula-based system of relations among the tiers of government to replace the outdated, nontransparent, and informal arrangements. During the early 2000s, the legislative framework was reformed, with significant amendments to the Tax Code and the adoption of the Budget Code. Uniform standards for the allocation of tax sources were established; expenditure responsibilities were clearly assigned among all levels of government, accompanied by the reduction of unfunded mandates; and fiscal discipline has gradually been strengthened. The federal government has established a system of incentives for the development of financial management in the regions and municipalities.

On the whole, the macroeconomic situation between the early 2000s and the 2008 crisis can be characterized as successful. A favorable external economic environment contributed to the growth of the Russian economy by an average of 7 percent per year. Inflation and unemployment gradually declined, while gold and foreign currency reserves demonstrated growth. Under these conditions, the federal budget had significantly improved and showed a surplus instead of a deficit. Thus, it was possible to dramatically decrease borrowing at the federal level and reduce the amount of debt to 8 percent of GDP.

Gradually, the financial capabilities of the Russian regions began to improve. In the majority of them, revenues grew faster than expenditures, which enabled the governments to improve current budget performance and, ultimately, to direct more resources to capital projects to maintain and restore worn-out infrastructure. During the 2000s, the credit culture of Russian SNGs strengthened significantly. Debt books were cleaned, and all questionable debts inherited from the 1990s were eliminated. Many regions continued to be dependent on federal government transfers, but the level and quality of support from the federal budget had changed significantly due to reforms in fiscal relations.

**Public Finance Reform in the 2000s**

For the federal government, the improved economic situation had provided an incentive to implement harmonized reforms in public finances aimed at a common goal: improving the quality of public
finance management at all levels of government—federal, regional, and municipal. Several important laws had been enacted, the most important of which was the Budget Code of the Russian Federation (January 1, 2000), which established the basic principles for the system of federal and subnational finances. The main provisions of the Budget Code in the area of debt relations will be discussed later.

The reform of intergovernmental fiscal relations was one of the most important for the Russian regions and municipalities. It addressed the following targets: (a) clear assignment of expenditure responsibilities across the tiers of government, (b) elimination of unfunded mandates to a lower level of government without provision of necessary financial resources, (c) allocation of taxes and tax shares among the levels of government on a long-term basis, and (d) formula-based equalization transfers to regional governments that took into account per capita fiscal capacity of a region and differences in costs of public services across regions.

Municipal governments were recognized as independent participants in fiscal relations, which became one of the fundamental features of the local self-government reform, as reflected in Federal Law #131 of October 6, 2003, “On General Principles Underlying the Organization of Local Self-Government in the Russian Federation” (“Law on Local Self-Government”).

The law established a uniform two-tier system of local self-government. The first tier included townships and rural villages, and the second tier included municipal districts consisting of several townships or villages and cities. The latter referred to major cities, such as capitals of regions and several large, developed cities with dense populations within a region.

The provision of the law stating that henceforth all levels of local government were full-fledged participants in economic and financial relations was revolutionary. It meant that all municipalities (including even rural settlements with small populations) were to set up municipal governments, employ municipal office staff, formulate and execute budgets, and conduct an independent debt policy. The law assigned a set of expenditure responsibilities to each level of local self-government (local government issues) and the Budget Code specified their revenue sources.
Before the reform, even large municipalities, including the capitals of regions, depended financially on transfers from regional governments. Municipal financial authorities were territorial subdivisions of the regional finance department. Most small municipalities carried out mandated financial activities given to them by higher levels of government. The 2003 “Law On Local Self-Government” actually prohibited such practice, and higher levels of government can no longer mandate activities to small municipalities.

The new system was to fully come into force on January 1, 2006. However, given the complexity of changes and the need for training of municipal officials, municipalities were given a three-year transitional period. Though some “brave” municipalities moved to a new system in 2006, most of them took advantage of the transitional period and completely switched to the new principles in January 2009, when the reform was finally implemented.

Since the second half of the 2000s, the federal government has been paying more attention to the quality of public finance management in the regions and municipalities. A Fund for Regional and Municipal Finance Reform (the Fund), to be administered by the Ministry of Finance, was established as part of the federal budget. The Fund was allocated among regions and municipalities on a competitive basis. Two separate competitions were held annually—one among the Russian regions, the other among the municipalities. Regions and municipalities participating in the contest had to prepare and submit to the Ministry of Finance a plan of the public finance reform in their jurisdictions. The areas to be reformed were delineated by the Ministry of Finance and included (a) improvement of the quality of public services, (b) introduction of a program-oriented budget, (c) raising revenue sources, (d) reforming the extended state (municipal) sector, and (d) debt management and estimation of debt capacity.

Regions (municipalities) were to identify the specific mechanisms of reform options and assess the implementation risks of planned activities. Annually, no more than eight winners were determined among both regions and municipalities whose programs were the most convincing. Also, they received funds only as a result of successful completion of the first and second stages of their plan. The received resources could be spent on funding the plan implementation, which usually covered a
wide spectrum of activities, including the purchase of computer hardware and software, organization of refresher courses for public (municipal) employees, fulfillment of social obligations, and debt repayment.

**Assessing Reform Results**

The reforms were certainly an important step toward a better quality of public finance management in the regions and municipalities. The reform proved to be efficient in the following areas:

- The revenue sources and expenditure responsibilities have been clearly assigned across levels of government and fixed in the legislation. A unified two-tier system of local self-government has been introduced across all Russia and secured by law.
- Unfunded mandates have been mostly eliminated. When federal legislation imposes additional expenditure responsibilities on lower-tier governments, the federal government allocates adequate funds to fulfill those responsibilities. This allocation takes place in a timely manner.
- A transfer formula has been introduced to equalize the fiscal capacity of regions and municipalities. This was especially important in view of the huge economic disparity among regions and the resulting uneven revenue capacity. The equalization formula, which has not changed much since then, is based on a proportional increase of per capita revenue capacity of regions below the national average. The formula also takes into account the differences in costs of public goods delivery.

Russian regions and municipalities have been encouraged to improve the quality of public finance management. The federal government has allocated grants to regions and municipalities introducing best principles in public finance management, including debt management procedures. These grants have been allocated on a competitive basis. However, the reform was followed by a number of backward steps in the following areas:

- The allocation of responsibilities among the levels of government has been modified every other year. These modifications prevent the regions and municipalities from pursuing a predictable and long-term fiscal policy. Moreover, these modifications are being
introduced by the federal government at the end of the fiscal year, when regional and municipal budgets for the next period have already been formulated. Regional and municipal governments have to amend their budgets in early January.

- The revenue sources of SNGs depend on transfers. Eighty-five percent of the regions receive transfers from the federal government in the form of equalization grants, and every region receives earmarked grants. The federal government has at its disposal 200 types of earmarked grants that are provided to regional governments. Each region might receive all 200 types or fewer. Since grants are a more or less permanent source of income, the regions have less incentive to develop their own revenue base. At the same time, the value of each grant is unpredictable before the fiscal year begins. However, the federal government has tended to reduce financial support to regions. Municipalities can obtain transfers only from regional governments. Regional transfer mechanisms usually replicate the federal transfer policy regarding regions.

As for municipalities, their revenue sources are indeed very limited. There are only two local (municipal) taxes: the personal property tax and the land tax. Their tax compliance is very poor because of problems with taxpayer registration. In addition, the administration of the land tax requires a cadastral valuation of land, which is within the power of the federal government, and the establishment of a fair market land price in the relevant documents. The portion of the federal shared taxes assigned to municipal governments by federal law (the personal income tax being the largest) improves the situation in regional economic centers. About 20 percent of regions grant additional shares of the regional taxes in favor of municipalities to improve municipal tax capacity.

- Implementation of the regional and municipal finance reform programs is often a mere formality and does not contribute to the actual quality of public finance management. For some regions and municipalities, the sole purpose of writing and implementing programs has become a way to obtain additional funds from the federal government. They hired consulting firms in order to develop and implement a detailed program. If some regional administrations were really motivated to improve the system of public finances,
others demonstrated a formal approach to the reform and did not bother with the details of the reform plan proposed by the consultants. Some regions abolished regulations whose adoption was part of the implementation of program activities after the money from the federal government had been obtained.

Despite these shortcomings, the reforms meant the emergence in Russia of an institutional environment to be further developed. With the adoption of the Budget Code, the sphere of public debt management regulations has also undergone significant changes.

**Major Provisions on Debt Management in the Budget Code**

The Budget Code contains provisions for regulating the subnational debt by specifying (a) the limits on the size of fiscal deficit, debt, and debt service; (b) regulations on external borrowing and guarantees; and (c) sources of deficit financing and structure and types of debt instruments.

As prescribed in the Budget Code, the budget deficit of a region should not exceed 15 percent of its annual revenues, excluding all intergovernmental transfers. Local budget deficits should not exceed 10 percent of annual revenues, excluding all intergovernmental transfers and (or) revenues from shared federal and regional taxes. The 2007 amendment to the Budget Code tightened those limits for highly subsidized regions and municipalities. The highly subsidized regions are those in whose budgets the share of intergovernmental transfers (except particular earmarked transfers) exceeded 60 percent of revenues (except particular earmarked transfers) of the regional consolidated budget. For such regions, the deficit should not exceed 10 percent of their revenues, excluding all intergovernmental transfers. For highly subsidized municipalities (where intergovernmental transfers exceed 70 percent of their revenues, except particular earmarked transfers), the deficit limit was established at 5 percent of annual revenues, excluding all intergovernmental transfers.

The Budget Code stipulates that the outstanding debt of a region or municipality should not exceed its annual revenues, excluding intergovernmental transfers. The 2007 amendments provide that the outstanding debt of the highly subsidized regions and municipalities should not exceed 50 percent of their annual revenues, excluding intergovernmental
transfers. The Budget Code also stipulates that the debt service of a region or municipality must not exceed 15 percent of expenditures of the relevant year. Table 12.1 summarizes fiscal and debt rules for SNGs as stipulated in the Budget Code and its amendments.

Before 2000, foreign borrowing by a region or a municipality was not expressly prohibited by law, but in practice, it could only be undertaken on authority of a special presidential decree. The right to place loans abroad before 2000 was granted by the Russian president to the cities of Moscow and St. Petersburg, Nizhny Novgorod, Moscow, Sverdlovsk, Leningrad, Orel and Samara Oblasts, Krasnoyarsk Krai, and the Republic of Komi. These regions had issued external debt in various currencies to finance their budget deficits.

The Budget Code enacted in 2000 set severe restrictions on external borrowing. Since 2000, the regions could only borrow in foreign currency to refinance existing foreign debt. Currently, only Moscow has maintained its presence in the Eurobond market. All other regional and municipal governments issue obligations only in rubles. The 2007 amendments to the Budget Code granted the regions an opportunity to borrow in foreign currency starting January 1, 2011. The prerequisite for this is financial independence of a region from federal support; that is, the share of federal transfers (excluding funding federal mandates) should not exceed 5 percent of own revenues. Also, the

Table 12.1 Fiscal and Debt Rules for Subnational Governments

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<th>Municipalities</th>
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<td>5%</td>
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<tr>
<td>Debt service/expenditure ceiling</td>
<td>15%</td>
<td>15%</td>
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<tr>
<td>Total debt/revenue (excluding transfers) ceiling</td>
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<td>10 years</td>
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<td>A ban on external (foreign currency) borrowing</td>
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a. Only those Russian Federation subjects in whose budgets the share of intergovernmental transfers was less than 5 percent during the past three years are allowed to take new loans from January 1, 2011.
Russian government would develop a foreign borrowing procedure for
the regions. However, at the time of writing, the procedure had not yet
been developed.

The Budget Code, and especially the 2007 amendments, regulate the
system of granting federal, regional, and municipal guarantees. Two
types of guarantees have been established: recourse and nonrecourse
guarantees. The recourse guarantee is a guarantee issued by a region or
municipality to take on an obligation to pay the debt of a third party,
with the right to claim the debt from the debtor. The called guarantee,
according to the Budget Code, is recorded as an account receivable and
not as an expenditure item. The nonrecourse guarantee is a guaran-
tee issued by a region or municipality to take on an obligation to pay
the debt of a third party, without the right to claim the debt from the
debtor. The called nonrecourse guarantee is subject to recording as an
expenditure item. In practice, both types of guarantees are widely used
by regions and municipalities.

The Budget Code also established the sources for budget deficit
financing and limited the size of the budget deficit, debt, and its service.
The sources of financing the budget deficit of a region or municipality
include the difference between (a) the funds received from the place-
ment of securities and funds allocated for repayment, (b) received and
repaid loans of credit institutions, and (c) received and repaid loans
from government and from international financial institutions. It also
includes changes in the balance of funds on accounts and other sources
of financing the budget deficit. More specifically, other sources include
proceeds from the sale of shares and other equity, foreign exchange rate
differences, and funds allocated for execution of government guarantees.

The Budget Code also established the structure of regional and
municipal debt and its types and maturity. The debt structure of regions
and municipalities is limited to government securities, intergovernment-
ral loans, loans from financial institutions, and guarantees. The max-
imum maturity of debt obligations is set at 30 years for the regions and
10 years for municipalities. At the same time, the federal government is
not liable for debt of regions and municipalities that are not guaranteed
by the federal government.

The 2007 amendments to the Budget Code included a require-
ment for regions and municipalities to record and register their debt
obligations in their respective financial statements. The recorded information includes the types of debt, the date of contracting the debt, and the date of repayment in full or in part, forms of security, and arrears. The information from regional and municipal debt books is subject to mandatory transfer to the Ministry of Finance, which monitors the regional and municipal observance of the constraints imposed by the Budget Code. If a region or municipality violates such constraints, it will be unable to incur new debt until the situation once again meets the requirements of the Budget Code.

The limit on the size of debt raises a question about the evaluation of a subnational’s creditworthiness. The size of debt itself is not the main factor affecting the creditworthiness of the government. Much more important are the structure of debt and the cost of debt service, namely, the period of repayment, the currency of borrowing, the interest rate, and the amortization of debt payment. The limit on budget deficit also raises an issue for financing large-scale infrastructure projects with major capital requirements. A severe limitation on the total amount of borrowing during one financial year may have a negative impact on the effectiveness of the investment policies pursued by regional and municipal governments, since regional and municipal governments may have to scale down the size of investment and lose the economies of scale in infrastructure networks.

Since guarantees are subject only to debt limits but not to current deficit limits, guarantees (nonrecourse) are being used by regional and municipal governments to finance their own expenditures through issuing guarantees in excess of deficit limits set by the Budget Code to the companies controlled by the relevant regional or municipal government that borrow on behalf of the government to finance government infrastructure projects. The funds to repay the company’s debt come from grants provided to these companies from regional or municipal budgets. This is a way to avoid restrictions on current deficits as long as the total debt stays within the legal limitations.

The Budget Code does not specify restrictions on the use of borrowed funds. Even though best practices recommend using borrowed funds for funding only capital investments, Russian SNGs still often borrow to finance current expenses such as payroll and maintenance costs. Unfortunately, the Budget Code does not prevent borrowing
to finance current deficits. Therefore, the most frequent explanation in financial statements under the “purpose of borrowing” entry is “to finance budget deficit,” without further specification of costs and projects to be covered by the identified resources.23

The Subnational Debt Market during 2000–08: Growing Interest in Credit Ratings
Favorable terms of international trade and successful domestic economic development in Russia, especially between 2004 and 2008, have largely neutralized negative aspects of the reform of intergovernmental fiscal relations for some of the Russian regions and municipalities. Their financial positions have strengthened considerably together with revenue growth.

Between 2003 and 2008, the aggregate revenues of SNGs more than tripled in absolute terms (while consumer prices nearly doubled). At the same time, there was a tendency in regional budgets to increase the share of current and social expenditures at the expense of capital spending.24 This was largely due to the social security reform started in 2005, during which the federal government encouraged regions and municipalities to increase public sector wages by 50 percent in real terms during 2006–08. However, the two-year period (2005–06) of nearly 15 percent real growth per year of budget revenues was over in 2007. To balance their budgets, SNGs had to curtail the growth of current spending. This was a difficult task, given the inertia of the budgetary process and decisions already taken to increase the wages of public sector employees.

The growing burden of current expenditures on regional budgets has been exacerbated by the reduction of intergovernmental transfers to regions (table 12.2). There is a large disparity in economic development among Russian regions; in fact, a major feature of Russian fiscal federalism is the large disparity in the revenue capacity of the regions. In 2007, for example, the wealthiest region was 38 times richer than the poorest region. Federal equalization transfers reduced the gap to eight times the fiscal capacity.25

From 2003 to 2005, the share of total federal grants to the regional governments declined from 19 percent of the aggregate income of regions of Russia to 15 percent and stayed stable until 2008. In 2008,
total grants grew to 18 percent of consolidated regional revenues and in 2009, reached 25 percent. As summarized by table 12.3, the federal government gradually shifted the focus in the area of intergovernmental fiscal relations from the equalization schemes to the stimulation of economic development of regions through special purpose transfers. The share of earmarked transfers for execution of federal mandates also rose. However, the debt load of the Russian regions remained low at the end of 2007 (figure 12.3). According to the Ministry of Finance, total debt of the Russian regions (excluding municipal debt) at the end of 2007 was US$18 billion equivalent, or about 11 percent of aggregate regional revenues, including fiscal transfers to regional governments in 2007. The regional debt was unevenly distributed across regions; five regions—the city of Moscow, Moscow Oblast, Samara Oblast, the Republic of Tatarstan, and the Republic of Sakha (Yakutia)—accounted for about half of the regional debt.

Another feature of the Russian regions’ debt was its short-term character. Short-term bank loans were a major debt instrument for most Russian regions (excluding the city of Moscow and Moscow Oblast, which were the two largest borrowers on the securities market at the time). What is more, most regions (excluding the city of Moscow) placed bonds for a term not exceeding three years. The majority of SNGs had little experience in debt management and had short credit histories.

During 2000–08, regions and municipalities showed increasing interest in obtaining credit ratings from the rating agencies. The number of

Table 12.2 Annual Growth of Subnational Revenue, Including Fiscal Transfers, 2004–08

<table>
<thead>
<tr>
<th></th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real growth, subnational (regional + municipal) revenues, including transfers</td>
<td>11.9</td>
<td>14.0</td>
<td>16.2</td>
<td>−3.9</td>
<td>33.9</td>
</tr>
<tr>
<td>Real growth GDP</td>
<td>7.2</td>
<td>6.4</td>
<td>8.2</td>
<td>8.5</td>
<td>5.2</td>
</tr>
<tr>
<td>Real growth, aggregated federal equalization transfers to regional governments</td>
<td>−8.6</td>
<td>4.5</td>
<td>9.8</td>
<td>2.0</td>
<td>11.0</td>
</tr>
<tr>
<td>Real growth, aggregated total federal transfers to regional governments</td>
<td>−4.2</td>
<td>2.4</td>
<td>27.5</td>
<td>−8.5</td>
<td>58.9</td>
</tr>
</tbody>
</table>


Note: GDP = gross domestic product.
ratings assigned to Russian regions by Fitch Ratings increased from only 4 in 2003 to 25 in 2008. However, the majority of ratings of Russian regions and municipalities belong to the so-called “speculative-grade” (from “BB” to “D” categories, according to the international ratings scale by Fitch); that is, they indicated a fairly high level of credit risk. Only a

Table 12.3 Intergovernmental Fiscal Transfers from the Russian Federation to Regions as a Percentage of Each Type of Transfer in Total Transfers, 2003–10

<table>
<thead>
<tr>
<th>Transfers</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>General grants</td>
<td>58</td>
<td>54</td>
<td>61</td>
<td>61</td>
<td>40</td>
<td>35</td>
<td>39</td>
<td>37</td>
</tr>
<tr>
<td>Of which equalization grants</td>
<td>45</td>
<td>43</td>
<td>39</td>
<td>47</td>
<td>31</td>
<td>29</td>
<td>25</td>
<td>28</td>
</tr>
<tr>
<td>Earmarked transfers for cofinancing regional programs</td>
<td>15</td>
<td>26</td>
<td>27</td>
<td>17</td>
<td>38</td>
<td>38</td>
<td>36</td>
<td>30</td>
</tr>
<tr>
<td>Earmarked transfers for execution of federal mandates</td>
<td>27</td>
<td>19</td>
<td>10</td>
<td>20</td>
<td>22</td>
<td>16</td>
<td>19</td>
<td>27</td>
</tr>
<tr>
<td>Other transfers</td>
<td>0</td>
<td>0</td>
<td>2</td>
<td>1</td>
<td>0</td>
<td>11</td>
<td>6</td>
<td>6</td>
</tr>
<tr>
<td>Total</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
</tbody>
</table>


Figure 12.3 Federal and Subnational Debt as a Share of GDP

Source: Author’s estimates based on Russian Federation Treasury data.

Note: GDP = gross domestic product.
few regions, including the federal cities of Moscow and St. Petersburg, the Republic of Tatarstan, and the Khanty-Mansi and Yamal-Nenets Autonomous Okrugs (according to Fitch Ratings and Standard & Poor’s), had ratings of “investment grade” (“BBB-” and above).27

Access to capital markets is limited to the most creditworthy SNGs. As shown in figure 12.4, Moscow Oblast accounted for over one-third of bond issuance, followed by the city of Moscow at 30 percent.

Lack of sustainable legal provisions and poor quality of debt management are the major constraints on increasing credit ratings of Russian regions and municipalities.28 As a result, the average long-term ratings of Russian regions in foreign currency are significantly lower than similar ratings in European countries. The difference between Russia and Poland, the nearest country in rank, is four steps on the international rating scale. Moreover, in Russia, there is the greatest gap between the country’s sovereign rating (long-term rating “BBB” in foreign currency)29 and the median rating of Russian regions (long-term rating “BB-” in foreign currency). In this case, the gap is four steps, whereas in other European countries it does not exceed one or two steps.30

Figure 12.4 Regions’ Share of Total Regional Bond Debt Outstanding at the End of 2008

Source: Author’s estimations based on regional fiscal reports on the RF Ministry of Finance website, http://www1.minfin.ru/ru/public_debt.
Despite the fact that the crisis in Russia began to develop in the fourth quarter of 2008, when industrial production in the regions began to decline, most of the regions demonstrated quite satisfactory fiscal indicators on a yearly basis. Due to a good economic situation in the first six months in 2008, the economic growth in most regions showed a positive trend on a yearly basis. Budget indicators also remained satisfactory. Only in some regions with large industries, which were more vulnerable to the crisis, did economic decline become apparent in 2008. This happened in Nizhny Novgorod Oblast, which was significantly affected by the financial woes facing the automobile industry (the industry has since recovered).

The Global Economic Crisis and Its Effects: Trends and Prospects

Impact in 2009
The global financial crisis that began to unfold in the fourth quarter of 2008 severely struck Russian public finances in 2009. The budget deficit in most regions had increased, owing to a sharp decline in revenues and an inability to cut expenditures. Federal support had helped mitigate the financing gap in many regions but was not enough to fully compensate for falling revenues. As a result, the regions faced significantly larger budget deficits. The fiscal deficit grew from US$1.8 billion equivalent (or 0.8 percent of total aggregated revenue and 1.1 percent of revenue net of transfers) in 2008 to US$8.7 billion equivalent (or 5.7 percent of total aggregated revenue and 8.2 percent of revenue net of transfers) in 2009, of which about US$4.6 billion equivalent was accounted by the city of Moscow. Part of the overall deficit was financed from fiscal reserves accumulated during the previous years. However, the larger part of the cumulative deficit in 2009 was covered by a more than 50 percent increase in borrowing by subnational entities. The new debt had shorter maturities that increased refinancing risks. Soaring interest rates also contributed to increasing debt service costs. Interest rates on bank loans reached 20 to 22 percent in some regions.

The impact of the crisis varied among regions and municipalities. The strong regions, which relied on their own tax capacity (mainly, the personal income tax and the corporate income tax), were among the
most severely affected by the crisis. These were the regions with well-developed industries. The regions that depended on exports (metal-lurgical and oil-producing regions) were also vulnerable. However, the regions with a greater dependence on federal transfers appeared to be less affected. On the whole, federal support to the regions during the crisis, mainly in the form of additional general purpose transfers, was the most important factor mitigating the consequences of the crisis for SNGs. In 2009, transfers increased by US$13.2 billion equivalent, or by 35 percent compared with 2008. This was a crucial difference from the 1998 crisis, when the Federation provided no support to the regions and left them on their own.

In 2009, bank loans and federal government loans became the main debt instruments of SNGs. Issuance of domestic bonds almost stopped in the first half of the year. The only exception was the city of Moscow, which issued bonds as early as January 14, 2009, to borrow US$460 million equivalent at a 10 percent interest rate, a lower rate compared with costs available for other regions in 2009. Throughout 2009, Moscow was an active player in the regional bond market, which allowed the city to maintain a long-term debt profile and a smooth structure of debt repayment.

In the second half of 2009, those regions that were traditionally financially stronger began to return to the bond market. But despite this, the number of issuers decreased from 23 regions in 2008 to 10 regions in 2009. The number of securities issues dropped even more substantially—from 35 in 2008 to 16 in 2009. Most other regions attracted short-term loans with a one-year maturity and interest rates that were as high as 20–22 percent per year in the first quarter of 2009. Subsequently, when the financial markets began to stabilize, a number of regions negotiated the reduction of interest rates for the remaining period to mitigate the significant growth in debt service costs. In 2009, the aggregate amount of bank loans attracted by the regions increased by US$1.7 billion equivalent compared to the previous year.

In 2009, federal loans to regions became very important. Together with additional subsidies, federal loans were another form of indirect federal support to the regions. The advantages of federal loans compared with bank loans were a lower interest rate and a longer repayment
horizon. In 2009, the federal government issued loans amounting to US$4 billion equivalent to regional governments, an eightfold increase over 2008.  

Starting in 2009, the federal loans were granted for three years. Previously, as mandated by the Budget Code, they were to be repaid within one year. The interest rate on federal loans was one-quarter of the refinancing rate of the Central Bank of Russia—a subsidized rate for the regions to finance budget deficits when access to loans was limited and interest rates in capital markets were extremely high. As mentioned, the market rates peaked at 20–22 percent in the first quarter of 2009, but they declined to 11–13 percent by the end of that year.

Federal loans can be divided into two groups according to their purpose. The first group of loans is the general purpose loans that are provided to cover current budget deficits. They, as a rule, have an amortized repayment structure; 60 percent of the principal is paid off in the second year and the remaining 40 percent in the third year. Such a structure smoothes out the peaks of debt repayment and makes the debt profile more favorable.

The second group is special purpose loans for construction, reconstruction, and repair of public roads. In this case, the principal is repayable at the end of the term. In 2009, the aggregate direct debt of the Russian regions increased to a US$23.8 billion equivalent, that is, by almost 60 percent over the previous year. However, compared to the total revenues of Russian regions in 2009, it constituted a mere 15 percent, which, by international standards, is quite manageable. The major problem for the Russian regions was not the absolute size of a debt load but its payment structure. Reduced debt maturity terms created a substantial risk for refinancing and high debt service costs—factors that put pressure on their budgets.

Also worth mentioning are the contingent liabilities of subnational entities that include guarantees and financial debts of affiliated regional and municipal enterprises in times of crisis. Despite the fact that on the eve of the crisis the popularity of guarantees had somewhat declined, SNGs still use them widely to support the local economy. During the crisis, regions used different tactics regarding guarantees. Some opted not to incur additional risk and in difficult financial conditions refused to issue guarantees to enterprises so as not to impose additional risks
on the government. At the same time, many regions supported major local taxpayers that faced great difficulties obtaining loans to develop their businesses. In that case, it was important to carefully select companies according to the most stringent criteria to mitigate possible negative consequences for the budget. The tightened rules envisioned by the Budget Code had also positively contributed to mitigating potential serious fiscal risks from guarantees.

Owing to the financial crisis of 2008 and the sharp deterioration in the construction sector, government mortgage agencies in several regions (Republic of Khakassia, Republic of Tatarstan, and Tomsk Oblast) were not able to pay their liabilities, which required provision of additional resources of the respective regional governments.

Novosibirsk Oblast provides an example of guarantee use in the difficult year of 2009. It granted about US$80 million equivalent of non-recourse guarantees to enterprises of the construction sector, a most vulnerable industry during the crisis. As a result, the construction sector, a major component of the service economy of Novosibirsk Oblast, showed an increase in housing construction in 2009 compared to 2008, which was extraordinary for the Russian regions in times of crisis. Moreover, despite the nonrecourse nature of guarantees, construction companies managed to pay their debt and not add pressure on the regional budget. Thus, in this case, the guarantees helped to substantially support an important sector of the economy and prevent a significant deterioration of the oblast budget execution process, which had been predicted by many.41

A distinctive feature of the crisis in 2008 that differed from the 1998 crisis was the lack of defaults of regions on their debt obligations. This was due to the additional support from the federal government and the liquidity accumulated in previous years by those regions that were able to foresee a possible deterioration in the economic and financial situation and prepare for it. Accordingly, credit ratings of most regions remained at the precrisis level. Those regions that were not able to restrain the growth of current spending in 2009 (and significantly increased their debts) were negatively evaluated by the rating agencies. Their ratings were downgraded or, in many cases, the forecast on ratings was changed to “negative.”
2010: Public Finance Improved, Debt Structure Remained Vulnerable

In 2010, after the 18-month crisis, a gradual recovery of the Russian economy took place within the context of the global economic recovery. In addition to a return to favorable international economic conditions for Russia’s major exports, there was a restoration of economic activity in general. Economic growth recovered from negative 7.8 percent in 2009 to positive 4.3 percent in 2010, and export growth increased from negative 35 percent in 2009 to positive 32 percent in 2010. This led to a significant increase in tax revenues, especially from the corporate income tax, an important revenue source for most Russian regions. In 2009, its reduction for regional governments amounted to an average of 40 percent compared to 2008. The level of industrial production in 2010 exceeded the precrisis level in half the Russian regions.42

The economic recovery contributed to public finance improvement at the subnational level. In 2010, the aggregate revenues of SNGs (excluding Moscow) increased by approximately 10 percent compared to 2009 (while the 2010 inflation rate was about 9 percent). At the same time, the revenue structure of SNGs changed in 2010; the regional governments became less dependent on federal transfers. Thus, the share of various transfers accounted for 32.5 percent of total SNGs revenues in 2010 compared with 37 percent in 2009.43 Despite the gradual recovery of tax revenue, especially from the corporate income tax, financial independence of the majority of Russian regional and local governments remains low.

In 2010, the increase in aggregate spending of the regions reached a moderate 9 percent, which is close to the inflation rate. However, the composition of expenditure changed: social spending increased, while capital expenditures decreased. The share of capital expenditures in the total regional budget expenditures decreased from 18 percent in 2008 to 13 percent during 2009–10. However, given the high demand for infrastructure development, lower capital spending in most regions should be considered a temporary phenomenon. A moderate increase in expenditure containment and an increased revenue base resulted in a lower consolidated deficit of regional budgets in 2010—1.6 percent of total aggregated revenue (compared to 5.7 percent for 2009) and 2.2 percent of revenue net of transfers (compared to 8.2 percent for 2009).44
In 2010, the debt markets recovered, and borrowing costs decreased. Though the debt load of the regions continued to increase, its growth rate declined. The aggregate regional debt remained moderate, at 20 percent of total revenue in 2010. At the same time, regional distribution of debt remained uneven. Ten regions accounted for about 57 percent of the total debt in nominal terms. The relative debt burden was also unevenly distributed; the median region’s debt constituted 16.5 percent of total income, while the maximum level of debt amounted to 60 percent of revenues (Astrakhan Oblast). Due to federal support, Russian regions compared favorably with SNGs in other European countries (figure 12.5).

Notwithstanding the low debt as share of regional revenue, the structure of debt in most regions has considerable room for improvement. Federal loans became the main source of deficit financing of regional budgets in 2010, accounting for 45 percent of the total direct debt (excluding Moscow). However, since 2010, the terms for repayment of federal loans was extended up to five years, which extends the maturity profile of debt for the regions. The share of bank loans as direct debt amounted to 31 percent of all SNGs debt (excluding Moscow). Interest rates on bank loans declined significantly in 2010 to 7–8 percent per year.

Figure 12.5  Outlook on Credit Ratings: Russian Federation Regions and Subnationals in European Countries, End-December 2010

![Bar chart showing credit ratings for various European countries and the Russian Federation regions, with a legend indicating negative, stable, and positive ratings. Source: Fitch Rating 2011.]
year and were close to the refinancing rate of the Central Bank of Russia. This has significantly reduced debt servicing costs. In addition, banks started to offer loans for longer terms, that is, for two to three years. However, not all regions are ready for longer-term loans because the interest rate on them is usually slightly higher than on one-year loans.

Activity in the domestic bond market remained moderate. Only 13 regions issued bonds in 2010 compared to 10 in 2009. New bond issues have also had a longer period—from three to five years—compared with one to three years in 2009.

These were nonmarket instruments for financing the deficit of subnational budgets, which predominated in 2010. Also, the debt repayment profile continued to be short, owing to the large share of short-term bank loans in the debt structure. The overall structure of regional debt differs fundamentally from the debt structure of the city of Moscow, where bonds with the maturity stretched to 2022 constitute up to 90 percent of the debt portfolio.

**Continuing Improvement in Subnational Fiscal Positions and More Active Subnational Debt Activities in 2011**

The fiscal outcomes for the regional governments improved in 2011; the deficit of the consolidated budget of the Russian regions was 0.45 percent of revenues (excluding transfers) in 2011, down from 1.53 percent in 2010. The deficit shrinking would have been stronger if not for the growth of spending commitments of all levels of government before the presidential election in 2012. On the spending composition, social outlays of the regions have outstripped their capital spending; in 2011, capital expenditures were reduced by 20 percent compared to 2008, while spending on social programs demonstrated a 71 percent increase. Though in 2011, regional incomes practically recovered due to the growth of tax revenues (in the first place, the corporate income tax), their expenditures also increased and almost reached their revenue level.

In 2011, the share of federal loans in the debt structure of the Russian SNGs continued to grow and reached more than 40 percent; these loans were provided at 4 percent per year, or at about half the minimum market rate.

During 2011, the debt of the Russian regions grew 13.8 percent in real terms, but the total debt stock remained manageable at the end of
2011. However, the structure of the debt profile remains risky. The short-term structure of the debt implies refinancing risks and the potentially high cost of repayment and debt service in the coming years.

While the average debt level for the regions was 18.3 percent of revenues (including intergovernmental transfers), in six regions, the debt level is 50–70 percent. Thirteen Russian regions had to spend over 15 percent of their income on debt service. The city of Moscow accounted for 20 percent of all regional debts. In 2011, the city executed its budget with a surplus, and borrowing, therefore, was not needed. A similar situation was typical for other “wealthy” Russian SNGs (for example, oil-producing Tyumen Oblast and Yamal-Nenets Autonomous Okrug), many of which were able to generate large financial reserves.

In 2011, the total volume of domestic borrowing of the regions and municipalities was reduced by 15 percent. The trend of relative growth of borrowing from commercial banks continued, with a reduction by one-third of the share of issues of securities. Securities accounted for 9.1 percent of the total amount of internal borrowing of consolidated regional budgets compared to 21.3 percent of federal loans and 70 percent of borrowing from commercial banks and international credit institutions, which reflected a shrinking bond market.

At the same time, the SNGs became more active in bond markets. The number of issuers increased; 21 regions and 5 municipalities registered bond prospectuses (compared to 17 regions and 6 municipalities that issued bonds in 2010). The three-largest issuers were responsible for 53.1 percent of total outstanding regional and municipal bonds in 2011. On the whole, the city of Moscow, which accounts for nearly one-half of outstanding bonds, continues to dominate the bond market.

According to the “Guidelines for the State Debt Policy in 2012–14,” approved by the Government of the Russian Federation, there will be fundamental changes in intergovernmental fiscal relations. The volume of federal loans to regional governments will be significantly reduced, and loans will be granted only “in case of emergency.” As a result, the document states, “there will be a growing need on the part of the Russian regions in market borrowing.” Thus, only two debt instruments would be available to the regions—bank loans and publicly sold bonds. In addition, the regions would have to return budgetary loans taken in the crisis, the peak of payments being 2012.
Challenges for Deepening Subnational Debt Markets

Key challenges facing the continuing development of subnational debt market include the following.

There is a need to develop sustainable legal provisions. Despite the fact that the system of intergovernmental fiscal relations began to take shape in the early 2000s, it is still under development. This entails an unpredictable change in intergovernmental fiscal design, which is a risk for each region and municipality in Russia. In recent years, the federal government has often decided to change the allocation of tax revenues, expenditure responsibilities, and transfer rules. At the same time, the share of flexible tax revenues in Russia—that is, revenues the regions and municipalities might influence (such as establishing a tax base or tax rate and administering the collection)—in most cases, does not exceed 10 percent of total revenues of the regional and local budgets.

The budget classification of Russia is subject to annual changes. In addition, due to the format of the budget classification (which is obligatory for every level of government), the grouping of revenues and expenditures into recurrent and capital ones can be achieved only through sophisticated and time-consuming analytical research. It is also not possible to obtain clear information on a number of crucial indicators of government performance in the area of public finance management and to do estimations of the true level of the debt burden.

Investment and debt policies are rarely coordinated by SNGs. According to best practices, all debt resources should be used only for investment purposes. However, in Russia, only a few regions operate under this scheme (the cities of Moscow and St. Petersburg, mainly). Most SNGs do not even try to compare their investment needs and volume of borrowing. This means that debt can be used both for investment and for current spending. In many respects, the underdeveloped legislation makes the situation even more serious and does not allow for realistic medium- and long-term budgeting and a long-term investment strategy.

The subnational debt portfolio remains short-term in nature. In the debt portfolio of most SNGs, one-year bank loans dominate, which leads to higher refinancing risk. In 2011, however, this situation did not cause particular concern because of the availability of sufficient liquidity in the Russian banking system. However, when liquidity tightens, the
creditworthiness of SNGs with a high proportion of short-term debt may face refinancing risks. Debt maturity and interest rate structure are among the most important parameters determining the quality of the debt portfolio of a region or municipality.

Bank financing of regions is dominated by a few state-controlled banks. Due to the underdevelopment of the banking system in Russia, bank financing of SNGs is dominated by a few state-controlled banks (primarily Sberbank and VTB). The dimensions of these banks, which are based on the past branch networks of the then Soviet-state banks, allow them to compete successfully with smaller-transaction banks, in terms of pricing. However, both Sberbank and VTB comply with strict market rules vis-à-vis their customers regarding issuance and repayment of loans.

There is a lack of comprehensive accounting for liabilities of government enterprises when assessing the total debt of a SNG. Financial debts of government enterprises (their bank loans and bond issues) are contingent liabilities of a subnational entity. The Budget Code does not include such contingent liabilities in the debt definition for regions and municipalities. This means that, formally, SNGs are not responsible for the debts of such enterprises, unless the debt is explicitly guaranteed by a government. For this reason, the vast majority of SNGs do not record the debts of their subsidiaries (partially or fully owned by a government) as a component imposing risks. Government enterprises submit their often incomplete and inconsistent financial statements with significant delay. At the same time, as recent events have shown, the regions must be involved in solving problems caused by the inability of affiliated companies to repay their debts.

**Conclusions**

The subnational debt market in Russia began to develop in the early 1990s. Unfunded federal mandates and political decentralization contributed to the growing demand for debt instruments, including foreign currency debt. At the same time, there was a complete lack of debt regulations and SNG lacked experience in managing debt risks. Debt was issued to finance recurrent expenditures, mostly with short-term maturities. With a rapidly deteriorating macroeconomic
environment in Russia in the late 1990s, refinancing risks facing SNGs rapidly rose. From 1998 to 2000, 57 of 89 regions defaulted on their debt.

Improved macroeconomic fundamentals during 2000–08 and substantial legislative reforms—significant amendments to the Tax Code, the adoption of the Budget Code, and the 2006 legislation on local self-government—contributed to positive changes in intergovernmental relations and to incentives to formulate new principles of financial management for the regions and municipalities. The current system of intergovernmental fiscal transfers allocation is formula based, extends to all levels of SNG, and takes into account key socioeconomic parameters. However, the formula changes often. Thus, the horizon for prediction of the amount of transfers is one or two years.

Russian legislation puts strict constraints on total debt amount, annual budget deficits, and debt service. Moreover, with revenue growth, the financial positions of the regions and municipalities have strengthened considerably. The debt load of the Russian regions remains low. Most Russian SNGs have no currency or derivatives risks. Debt management and budgeting processes have become more transparent. The Treasury and the Ministry of Finance of the Russian Federation publish updated information and data on budget execution and debt obligations on a regular and timely basis.

The 2008–09 global financial crisis struck Russian public finances in 2009, though the impact varied across SNGs. But there were no regional defaults, owing to support from the federal government and the liquidity accumulated in prior years by the regions. Since 2011, subnational fiscal positions have improved along with a gradual recovery of the Russian economy. The debt markets have recovered, and borrowing costs have decreased. Activity in the domestic bond market remained moderate until 2011, when the market expanded.

There are continuing challenges in subnational debt market development. Most SNGs have a short-term debt profile dominated by one-year bank loans, implying higher refinancing risk. Bank financing of regions is dominated by a few state-controlled banks. There is a lack of comprehensive accounting for the contingent liabilities of government enterprises. Debt management will need to be an integral part of fiscal policy and will need to be integrated into the budget planning and execution
process. It is necessary to coordinate debt and investment policies and to extend the horizons of budget planning. Subnational entities should develop a detailed medium-term fiscal framework that forecasts financing gaps. The borrowing plan should include information on attracting the new loans, their rates, and the repayment schedule of new and existing debt obligations, including contingent liabilities.

Notes

The findings, interpretations, and conclusions expressed in this work are those of the authors and do not necessarily reflect the views of The World Bank, its Board of Executive Directors, the governments they represent, or any other institutions with which the external authors may be affiliated.

1. Subnational governments in Russia include (a) governments of the subjects of federation (the official term, but informally called “regions”), and (b) local self-government or municipal governments (the official terms, but informally called “local governments”).
12. Among them the Republics of Sakha (Yakutia), Komi, and Tatarstan, as well as Novgorod, Samara, and Irkutsk Oblasts and several other regions.
13. Moscow and St. Petersburg are also called Federal Cities, which have the status of subjects of the RF (in other words, regional governments). All other cities have the status of municipalities.
18. The Law on Local Self-Government refers only to municipalities. Hence, in this chapter, “local government” is consistent with “municipalities.”
23. Based on author’s technical assistance to regional governments.
25. By comparison, disparities in subnational revenues (richest to poorest per capita) in the Philippines are equal to 35.4 before grants, 28.1 after grants; and in Brazil, 9.3 before grants, 4.9 after grants (Braga et al. 2002).
28. Fitch Ratings 2008b. According to Fitch’s methodology, the regions are assigned both a local currency long-term rating and a foreign currency long-term rating, even if the regions do not borrow in foreign currency (the level of these ratings is the same for Russian regions). This is done to enable a comparison of the level of ratings of the regions from different countries using Fitch’s unified international scale.
29. As of June 1, 2012, the long-term rating of the RF on the Fitch Ratings international scale is “BBB” with a “Stable” outlook.
33. Author’s estimations based on regional fiscal reports on the RF Treasury website, http://www.roskazna.ru.
34. Fitch Ratings 2011a.
35. Author’s calculations based on regional fiscal reports on the RF Treasury website, http://www.roskazna.ru.
38. Author’s estimates based on RF Treasury data on the RF Treasury website, http://www.roskazna.ru.
39. As of June 1, 2011, the refinancing rate of the Central Bank of Russia was 8.25 percent.
41. Fitch Ratings 2010.
43. Author’s estimations based on regional fiscal reports on the RF Treasury website, http://www.roskazna.ru. Thirty-seven percent is the average. In 15 regions, the share of transfers was between 50 and 90 percent.
44. Golovanova 2010.
45. Author’s estimations based on regional fiscal reports on the RF Treasury website, http://www.roskazna.ru.
46. Author’s estimations based on regional fiscal reports on the RF Treasury website, http://www.roskazna.ru.
47. Author’s estimations based on regional fiscal reports on the RF Treasury website, http://www.roskazna.ru.
52. Author’s estimations based on regional fiscal reports on the RF Treasury website, http://www.roskazna.ru.
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