Fiscal Federalism in Russia: Progress and Challenges

This Chapter was written by Deborah Wetzel.

I. Executive Summary

In the past decade, the system of fiscal federalism in the Russian Federation has undergone significant change and considerable strengthening. Relations between the center and the regions have been made more systematic, responsibilities have been clarified, revenue assignments have shifted, and a number of rules-based transfer systems have been put in place. These changes will continue in the coming years as recent proposals set out by the Kozak Commission have been put into law and are due to take effect between now and 2006. While many of the proposed changes strengthen the system, they do so at the cost of the autonomy and discretion of local level governments. Some of the key issues and challenges that arise are as follows:

Care will need to be taken in the implementation of the new structures of local government. Putting in place similar structures of local government across regions makes the system administratively simpler, but a few problems may arise. The role for municipal raions, which fill the gaps between urban districts, appears to be too ambitious. Certain functions such as addressing emergency situations might be better left to the regional level. The current approach may also prevent many cities that provide services to individuals beyond their borders from claiming the status of urban district. A process will also be needed to assist local governments in managing the redistribution of property that will go hand in hand with the reform. An additional issue is assuring that the right of dismissal that regions will have with respect to local governments is not abused. It is also clear that there are substantial issues of capacity that will need to be addressed at the local government level, both with municipal raions and urban districts, as well as with settlements. The Government may wish to consider the creation of a technical assistance program focused on assuring that the implementation of the new structures of local governments goes smoothly.

The improvements in the assignments of responsibilities for different levels set out in the Kozak reforms will require that considerable other legislative work be carried out. In addition to the approval of the laws on state administration and local self-governance that were proposed by the Kozak Commission, there are some 153 sectoral laws that need to be amended and some 35 federal laws that need to be repealed to make these new assignments effective. Many of these laws affect particular interest groups, veterans, the disabled, and key social sectors. Revision will require removal of central government mandates that have been longstanding. In the new proposals on expenditure assignments, there are a number of responsibilities for which coordination among governments will be very important—roads networks, delivery of water and energy—but the mechanisms for this coordination are not very clear. In addition, the assignments give considerable responsibility to the settlement level, but this may overload them. Finally, the assignment of key social welfare provisions to the regional level may exacerbate
inequalities among rich and poor regions. While the approach is meant to provide a solution to the problem of unfunded mandates, it may create new problems with respect to regional disparities.

There is a severe imbalance in the Government’s approach to fiscal federalism, expecting responsibility and accountability on the expenditure side but providing little or no autonomy or control on the revenue side. Although expenditure responsibilities continue to increase at local government levels, they have less and less control over their sources of revenue. This breaks the relationship between service delivery at lower levels of government and the taxes provided to pay for those services. Continuous monitoring and oversight will be required to assess how revenue assignments match up with expenditure assignments.

Implementation of new transfer mechanisms, parallel to those of the center, may not provide the transparency and predictability that are essential for a transfer system to work well. The system of transfers proposed at the regional and lower levels of government is fairly complex, and it is not yet fully clear how the multiple mechanisms for equalizing basic service delivery in settlements will fit together. A good deal of work is needed to develop the specifics of the formulas for the various transfer mechanisms and their overall impact. Changes in the transfer system also suggest a significant shift for localities away from tax-based sources of revenue to earmarked transfers, implying a further decline in discretion over their budgets. Finally, the implementation of the proposed system of transfers is likely to require both data and capacities that some regions and local governments do not have. A significant effort at providing technical assistance will be required for effective implementation of the proposed system.

II. Fiscal Federalism in Russia: Progress and Challenges

The Russian Federation has a population of some 146 million people, and covers a vast land area of 17.10 million kilometers (almost twice the size of Canada, the next-largest country in terms of land mass). There are 89 Subjects of the Federation (oblasts, republics, territories, and autonomous regions). At present, there are about 29,541 local administrations in Russia, of which only 4,200 form truly autonomous local budgets (Kurylyandskaya 2004a; and Kurylyandskaya, Nikolayenko, and Golovanova 2002). Within regions, the structure of government varies, with local governments established at the level of large cities and raions in some regions, at the level of cities and settlements in others regions, and in a combined raion and sub-raion type of local self-government organization in yet other regions (see below) (Kurylyandskaya, Nikolayenko, and Golovanova 2002:17). This varied structure of local government, combined with differences among regions in climate, endowments, and economic base, make effective fiscal management at the national and regional levels quite complex. Addressing the complexities and scope of intergovernmental relations in Russia is thus an enormous task.

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1 In the remainder of the document we refer to Subjects of the Federation as regions.
There are a number of objectives that Russia’s system of fiscal federalism tries to achieve:

- **Economic efficiency:** Providing public services at the most cost-effective level and developing long-term institutional incentives for subnational governments to support a competitive and enabling investment and business climate;

- **Fiscal responsibility:** Managing public resources on behalf of and in the interest of the population, with the most efficient use of tax and other resources to provide public services and ensure transparent and accountable fiscal policy;

- **Social equity:** Equalizing access to basic public services and social benefits irrespective of location;

- **Political consolidation:** Achieving agreement on the distribution of authorities among different levels of government in order to bring efficient service provision “closer to the people” and to help develop civil society;

- **Territorial integration:** Establish an integrated fiscal system by reducing imbalances in regional development and strengthening the territorial integrity of the country.

International experience suggests that the key to an effective system of fiscal federalism that meets the above objectives lies in the incentives that the structure of intergovernmental finance creates. Clarity of expenditure and revenue responsibilities is critical, as is the ability of the system to appropriately fund responsibilities at each level and to address inequalities as they arise. The ability to hold each level of government accountable for its actions and the services it provides is also important for an effective system of fiscal federalism.

Since the early 1990s, the Russian Federation has made enormous progress in the development and strengthening of its system of fiscal federalism. From a system based on bargaining and secret bilateral agreements between the center and regions has evolved a much clearer and systematic approach, as embodied by the proposals of the Kozak Commission. Nevertheless, significant challenges remain in strengthening the system and creating an optimal set of incentives for the different levels of government. After briefly setting out the progress that has been made in the evolution of fiscal federalism since the early 1990s, this Policy Note will discuss some of the key policy challenges that still remain.

**The Evolution of Fiscal Federalism in Russia**

Since the early 1990s, the evolution of fiscal federalism has gone through several stages, with important effects on regional fiscal management, which in turn have affected the macroeconomic situation. From 1991 through 1993, intergovernmental finance was dominated by the evolving political situation and conflicts and compromises between the
Regional budgets were based on negotiated expenditure norms, customized revenue sharing rates, and bargained transfers. The share of subnational budgets in the consolidated budget increased from 40 percent in 1991 to about 55 percent in 1993, and the role of subnational governments in the economic sphere increased. The new Constitution enacted in 1993 gave considerable powers to the executive relative to the parliament and the regions, but stopped well short of concretely defining powers and settling past disputes. The Constitution also allowed the Federal Government to establish bilateral treaties with a large number of regions, which significantly affected the incentives of the region. It soon became apparent that those regions that were “most difficult” received greater transfers and subsidies from the center.

In 1994, the Federal Government took a first step in reforming the system of fiscal federalism. Uniform sharing rates were established for all major taxes shared between the Federal Government and regional government, and a formula-driven equalization transfer was incorporated into the budget. In addition, the taxing powers of regional and local governments were expanded. However, unfunded mandates remained significant, expenditure assignments remained murky, the uniform tax-sharing assignments were not respected by the regions, and limitations both in the nature of the formula for equalization and in its overall funding caused general dissatisfaction with the results, and led to increasing reliance on negotiations to influence the outcome. Regions had little incentive to reduce expenditures and increase tax collections. The bilateral treaties and special fiscal treatment to many regions created mounting fiscal pressure.

Even before the crisis of August 1998, political awareness was mounting with respect to the effects of the system of fiscal federalism on overall budget policy. In late 1997 and 1998, the Government introduced a set of significant reforms just before the devaluation and financial crisis occurred. Reform included a revised Tax Code, Budget Code, and the Law on Financial Foundations of Local Self-Government (approved in September 1997). In 1998, just before the crisis, the Government adopted the Concept of Reform of Inter-Governmental Fiscal Relations in the Russian Federation for 1999–2001. The Concept laid out a three-year strategy for the reform of intergovernmental finance. Notably, this concept suggested for the first time that the Federal Government has a role in improving the intra-regional system, which, until that point, had been left to the discretion of the regional governments. In order to address the problem of unfunded mandates efforts were made to further clarify the roles and responsibilities of the different levels of government. Just after the crisis the Government began a recentralization of revenues. The share of taxes assigned to the Federal level in 1997 was 42.5 percent; by 2001 it had reached 60 percent.

In August 2001, the Government approved a new program of reforms for the system of fiscal federalism for 2002–05. Also in 2001, President Putin appointed a high-level commission for redefining and reforming intergovernmental fiscal relations in Russia. The work of the commission, which became known as the Kozak Commission, led ultimately to the approval in September 2003 of two laws on the reform of regional

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2 The term “unfunded mandates” refers to mandatory responsibilities and/or requirements placed upon lower-level governments without the requisite financing.
and local government. These laws, combined with changes in the Tax and Budget Codes, imply some significant changes to the system of fiscal federalism in the years to come, including: a dramatic shift in the organization of local governments, further important changes in the assignments of expenditure responsibilities and the elimination of unfunded mandates, continued emphasis on the centralization of revenues, and reforms to the system of transfers within regions. Each of these changes poses special challenges, to which we now turn.

**Changes in the Organization of Local Government**

One of the most important changes proposed as a result of the Kozak commission and the laws it has generated is the change being proposed to the organization of local government. Under the 1995 law, “On the general principles of the organization of local self-government,” the possibilities for the organization of local governments are quite broad. This law also grants uniform legal status to all local government entities, implying that all local governments enjoy the same institutional and administrative rights and cannot be subordinated to another local government (Kurlyandskaya, Nikolayenko, and Golovanova 2002). Over time, several models have developed based on the preferences of the regional administrations (Figure 1).
Forty-eight regions have developed a system (Type I) in which the region deals with one level of self-government at the level of cities and raions. In this system the sub-raion/settlement level is governed by the offices of the raion local government. Fiscal relations between the regional and raion/city government are designed and determined by the regions. Some 17 regions have a structure in which there is a deconcentrated tier of local government at the raion/city level, with a level of elected local government municipalities and settlements (Type II). In this arrangement, the authority to set local taxes is vested at the raion level, and the budgets of municipalities are incorporated into the regional budgets as expenditure plans. Municipalities in this system are therefore denied some of the powers established for them by federal legislation. Twenty-two regions have two levels of elected local governments, one at the raion/big city level and another at the sub-raion/municipality level. Local governments of the first level engage in direct financial relations with the regional authorities, whereas financial relations between the regional government and the second level are indirect.

Over time, a number of issues have arisen that have limited the development of local self-government. A first issue is the wide variety of systems and their implications for the application of federal legislation. The magnitude and formal authorities of the different levels of government vary significantly from region to region, making it very difficult to develop legislation that can appropriately address local government issues. Issues such as unfunded mandates at the local level and questions related to the allocation
of revenues among different levels persist. Finally, the variety of approaches also contributes to a lack of transparency in intraregional fiscal relations.

The changes in the recently approved law, “On the General Principles in the Organization of Local Self-Governance in the Russian Federation,” essentially mandate a uniform two-tier structure beginning in 2006. There are two tiers of elected local government, both of which make a distinction between urban and rural. The first tier is composed of municipal raions and urban districts, and the second tier consists of rural and urban settlements (Figure 2). This approach moves away from the regional variation that has developed in recent years and harkens back to the hierarchical approach in place during Soviet times.

**Figure 2. Local Government Structure from 2006 Onward**

The entire territory of the Russian Federation will be divided into urban districts and municipal raions, and all urban or municipal settlements will be incorporated within the relevant district/raion level. Municipal raions will also include sparsely populated “intersettlement” territories within which no subdistrict entities exist.

In contrast to earlier legislation, the new law also regulates the minimum and maximum size of municipalities. To become a second-tier entity, an entity should have the status of a town according the administrative–territorial codification, or represent a rural territory with a population of more than 1,000 people in one settlement, or be a rural territory including several settlements regardless of their population. The boundaries of a settlement or district/raion are determined by the walking distance to the center during working hours and the commuting distance to the center during working hours, respectively.
In addition to being directly elected, the representative body of a municipal *raion* may also be formed from the Council members of the constituent settlements.

While the new laws prohibit the subordination of one local government or official to another tier of government, there are a number of mechanisms through which regional authorities can exercise their influence. Regional authorities are authorized to participate in the selection of a municipal Chief Executive Officer, if such a post is established by the municipality, and in the selection of the municipal head. The new laws also streamline the procedures for the removal of local officials or dismissal of local councils by the regional authorities. Grounds for dismissal of a local head now include issuing a normative act violating federal or regional legislation; or any action determined by the courts to abuse human rights, threaten the unity and inseparability, national security, defensive capacity, unity of the legal or market system of the Russian federation, and mismanagement of subventions from the federal or regional budgets. The new laws eliminate the previous provisions that the local government of a regional capital can be dismissed only by the federal authorities. Federal authorities no longer will play a role in the dismissal of local authorities.

International experience (see Box 1) suggests that this two-tier approach may well be a suitable approach to organizing local governments in Russia’s regions. However, there are a number of issues that the government will need to take into account as it implements this legislation:

*The role for municipal raions may be too ambitious.* Under the proposed organization of local self-government, municipal *raions* are meant to address issues that arise in intersettlement areas of their territory, including the prevention of and response to emergency situations, environmental protection, zoning, and control over use of land in the intersettlement areas. This may be particularly burdensome in the very large and sparsely populated regions in the East and North of the country. Municipalities may have difficulties not only with respect to resources, but also with respect to their capacity to address some of the functions they are expected to cover in these large and scarcely populated regions. In some of these areas, certain functions, such as responding to emergency situations, may be better placed with the regional authorities.

*The definition of an urban district may preclude many cities from attaining this status.* The functions and services of urban districts as set out in the law are all meant to be carried out within the boundaries of the urban district. If the law is followed to the letter, an urban district (for example, city) that provides services such as hospital care to those beyond the population of the city (to those residing in the surrounding municipal *raion*) may not be entitled to the classification of urban district. Such “spillover effects” of services are common in large cities throughout Russia, so it will be important to determine how this affects both the classification of urban districts and the delivery of public services. Practically speaking, such “spillovers” are often addressed with arrangements between the urban district and the surrounding area.
Redistribution of property may be contentious. The implementation of a uniform, two-tier structure is likely to raise contentious issues of what belongs to whom as these structures are being established. While the functions of each level are set out relatively clearly (see below), there may be a need to redistribute property and assets, and it is not clear how this is meant to proceed. As the Russian Federation prepares for implementation of these laws in 2006, it is very important that the procedures and processes for this redistribution be set out in a way that is transparent and that can be readily monitored.

There are substantial issues of capacity that need to be addressed. Given the existing structures of local government, the creation of these new tiers of local government throughout the Russian Federation imposes more changes on some regions than on others. For most regions, however, there will be a need to assure that each of these new forms of local government understands its responsibilities and functions and has the capacity to deliver them. This includes an understanding at each level of developing programs to meet their responsibilities; preparing, executing, monitoring and evaluating budgets; and assuring the delivery of public services. There is a considerable amount of work to be done to prepare local governments, especially those at the urban and rural settlement level, to meet the new challenges they will face. As part of implementation of the new laws, the Federal Government may wish to consider providing, either directly or through the regions, local government with some training and technical assistance to assure that implementation of the new law will go smoothly.

Assuring that the right of dismissal is not abused. The right to dismiss local governments that have contravened federal or regional legislation and or pursued other objectives beyond the scope of their authority is an important check on misuse of local government power. However, there is the potential for this authority to be misused. The rationale for dismissal stated in the law could be interpreted in a relatively broad way, leaving regional administrations a powerful device for influencing what happens at the local level. Also critical to the effective use of such a system is the independence of the courts. To the extent that courts are not unbiased and independent, the new legislation may also be undermined. Setting out the process and procedures under which a local government may be dismissed in a much more specific way, with checks on both local and regional authority, may help safeguard the effectiveness of the right of dismissal.

Overall, the approach to the organization of local government set out in the law has pluses and minuses. On the plus side, it helps to create better clarity of structures within the regions, and makes it somewhat easier for the center to propose legislation related to local government as a whole. In theory, it should help to rationalize expenditure assignments and revenue allocations (see below for more on this). In practice, however, it remains to be seen whether the application of a similar structure across vastly different regions in terms of size, wealth, and ability to deliver services will be implemented effectively. Certainly the imposition of local government structure from the center
reduces the federal nature of the system in which regions could determine the system that worked best for them.
Box 1. Local Government Structures Vary Around the World

Larger federal governments often have a need to be flexible in their approach to local government structure, because a single approach may not meet the needs of different regions within the country. In some Federal Governments (including the United States and Canada), it is completely left up to the state governments to define local government structure.

For example, in the United States, most states rely on several levels of government. The first tier under the state level is the county, which is governed by locally elected boards. Within the 50 states of the United States there are 3,043 counties. A second tier of municipal (city)- or township (town or village)-level governments provides general local government services. In addition to these general-purpose governments, most states also rely heavily on special purpose districts to provide specific services such as education, water, and housing. Such special-purpose districts are run by elected boards, and boundaries are often determined in order to provide an appropriate scope for service delivery. Municipal, township, and special purpose governments are all part of one level of government and are not hierarchically organized—they deal directly with the state government and do not go through the county government. In Canada, states also have the authority to determine the structures of local self-government. The German Länder have less choice in determining local government structure, but a variety of structures still exist. Some Länder have local government structures of small size, and others have large local government structures.

Several trends occurred in the developed countries over time with respect to local government structures. Many Northern European countries (Denmark, Finland, Norway, Sweden, and the Netherlands) undertook consolidation of local governments in order to achieve a minimal size of basic authority from between 8,000 to 10,000 people. This was viewed as the appropriate scale for delivery of a variety of important services. However, after the consolidation took place, advisory and executive authorities were created at the submunicipal level in order to bring local government closer to the people. In contrast, countries in southern Europe (France, Spain, Switzerland) maintained small local governments, with populations in the low thousands. This has encouraged upward delegation of functions and development of approaches to intermunicipal cooperation such as intermunicipal associations.

International practice varies with respect to differentiated treatment of localities within a given region. In those countries with consistency in size and administrative capabilities of local governments, all governments are often treated the same. Typically these are small homogeneous countries. In nonhomogeneous countries, with a large variation in size and capacities, local governments with different characteristics are classified according to some scheme, typically size and capacity, and given responsibilities accordingly. This latter is the more common approach internationally.

Source: Martinez, Timofeev, and Boex (forthcoming), Appendix 3.2.
Strengthening Expenditure Assignments

Expenditure assignments are at the heart of the system of fiscal federalism in that they set out the responsibilities of each level of government. They have been under continuous revision in Russia since the early 1990s. Over the years, expenditure assignments have been gradually improved, although they still suffer from a number of drawbacks. First, they are typically not well defined in terms of all levels of government; they usually focus on the responsibilities of the center and the regional levels of government. Responsibilities for local governments within the regions were not well defined, and were often determined by the regions themselves. Second, expenditure assignments have typically set out a number of responsibilities to be shared among levels of government, with very little specification of how this sharing is meant to take place (for example, which level regulates, which level finances, and which level actually provides the service). Third, assigned responsibilities have been oriented toward looking after existing institutions as opposed to being oriented toward the provision of services to the community. For example, localities that do not have school buildings had no need to look after provision of education services, even though in localities with schools it is considered a local function. Finally, and perhaps most important, the existing system of expenditure responsibilities has created a severe problem with unfunded mandates, whereby responsibilities are given to a particular level of government, but no provision is provided for the necessary resources to carry out those responsibilities.

The laws embodied in the recent reforms also try to address these problems. They specify the responsibilities of each level of government, including the new tiers in local government. Table 1 sets out the major changes in expenditure assignments with respect to the center, regional, and local governments. A few items are particularly noteworthy. Under the new laws, determination of public wages will be the responsibility of each level of government, as opposed to being determined by the Central Government. This allows localities some discretion in controlling their wage bill. Subsidies to agriculture are now to be provided at the regional level, whereas subsidies to other non-state-owned enterprises will be determined and provided by the Central Government. A very important change, one that is key to reducing unfunded mandates, is that regions will now be responsible for determining and funding many social policies, including child allowances, and support to the disabled, low-income families, orphans, and the like. Regions will also be responsible for specialized health care.

The new laws also provide separate assignments for the different levels of local governments. At the settlement level, the legislation assigns the following responsibilities: provision of electricity, heating, gas and water supply, wastewater collection, and provision of fuel to households within the settlement; maintenance and construction of roads and bridges and other transportation within the boundaries of the settlement; provision of housing to low-income residents; organization of construction and maintenance of the municipal housing stock; transportation services; emergencies and fire safety within the settlement; library services; culture and entertainment facilities;
Table 1. Changes in Responsibilities Resulting from the Kozak Laws

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<tr>
<th>General Government Functions</th>
<th>Federal</th>
<th>Regional</th>
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<td>Army recruiting</td>
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<td>Police (regional responsibilities)</td>
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<td>Fire protection (except extraordinary cases)</td>
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<td>Birth and death registration</td>
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<td>Wage regulation in the public sector</td>
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<td><strong>Subsidies to Producers</strong></td>
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<td>Subsidies to agriculture</td>
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<td>Subsidies to other non-state-owned enterprises</td>
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<td><strong>Welfare Policy</strong></td>
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<td>Social benefits to: elderly, disabled, honored pensioners, victims of Stalin regime, low-income families, orphans</td>
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<td>Allowances to families with children</td>
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<td>Social benefits to: war veterans, Chernobyl victims</td>
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<td><strong>Education</strong></td>
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<td>Vocational education</td>
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<td>Salaries of primary, secondary, and high school teachers</td>
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<td>Preschool education</td>
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<td><strong>Healthcare</strong></td>
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<td>R&amp;D in health care, expensive treatment</td>
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<td>General health care</td>
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Note: A solid line indicates transfer of regulation, funding, and delivery.  
A dashed line indicates transfer of funded delivery only.  
Source: Kurlyandskaya (2004b).

- protection of cultural heritage; development of fitness and sports activities; recreation;  
- archives; collection and removal of household waste and trash; landscaping; settlement planning and zoning; street lighting; and provision and maintenance of cemeteries.

*Municipal raions* are assigned the following functions: organization of electricity and gas supply to the settlements within the boundaries of the municipal raion; construction and maintenance of roads and bridges outside the boundaries of settlements.
but within the boundaries of the municipal raion; transportation; protection of public order within the territory of the municipal raion; environmental surveillance over industrial and social facilities in the territory of the municipal raion; organizing the free provision of public education, including primary, basic, secondary (full) general education; preschool education in the territory of the municipal raion; emergency medical services; inpatient and outpatient primary medical care services, health services for pregnant women, obstetric care; recycling of household and industrial waste; zoning within the municipal raion; keeping the cadastre of land use and town planning documentation; municipal archive; intersettlement burial sites, library services, and equalization of the budget capacity of settlements included in the municipal raion, at the expense of budget funds of the municipal raion.

Responsibilities assigned to urban districts are basically an amalgam of the responsibilities of both municipal raions and settlements set out above, but applied within the boundaries of the urban district. For example, urban districts are responsible for, among other things, the provision of electricity, heating, gas, water supply, wastewater collection, and provision of fuel to households within the boundaries of the urban district; construction and maintenance of roads in the urban district; and provision of housing to low-income residents. Unlike other levels of local government, urban districts are provided the right to decide on other issues outside the scope of competence of other municipalities and state authorities, subject to the availability of own resources.

The new legislation certainly clarifies the roles and responsibilities of the various levels of government, and makes an enormous contribution by focusing the responsibilities of local governments on functions as opposed to maintenance of institutions. However, there are a number of important issues that arise:

- Implementation of the new expenditure assignments may be difficult. The new laws on regional and local self-governance set out an improved framework for expenditure responsibilities. However, approval of these laws alone is not sufficient for such responsibilities to take effect. There are some 153 sectoral laws that need to be amended and some 35 federal laws that need to be repealed to make these new assignments effective. Many of these laws affect particular interest groups, including veterans and the disabled, and key social sectors. Revision will require removal of central government mandates that have been longstanding. Despite the strong support for the Government in the Duma, it may prove difficult to make all the legislative changes required for implementation of the new legislation regarding expenditure responsibilities to become effective.

- Coordination mechanisms are unclear in areas for which more than one level of government has responsibility. In the expenditure responsibilities discussed above, there are some cases in which each level of government is assigned the same responsibility within its own boundaries. These cases include organization of electricity and gas supply, construction and maintenance of roads and bridges, and transportation services. Given that provision of these types of infrastructure calls for the development of coherent networks, it will by default require some degree of
coordination among and between the different levels of government. Yet how this coordination will occur among these entities remains unclear. For example, while it is clear that regional governments will have some say in the construction and maintenance of major, regionwide roads, to what extent will the region be involved in the development of the network of roads at the urban district, municipal raion, and settlement level?

The responsibilities assigned to the settlement level may overload them. As described above, the settlements have been assigned significant responsibilities in the new system. Recall that the size of a settlement may be a minimum of 1,000 people or a conglomeration of a number of settlements of any size. When the range of responsibilities is considered, such as provision of electricity, heating, gas, water supply, and fuel to households; provision of housing to low-income residents, including organization of the construction and maintenance of housing; construction of roads and bridges and other transportation facilities delivery of transportation services; libraries and cultural facilities; and fitness and recreation, this may be quite a heavy load for some settlements to bear. Certainly the sources of revenue for the provision of all such services have not existed at this level in the past, and it is not clear that the current plans will alter this much (see the discussion of revenue assignments in the next section.) This will be of particular concern for rural settlements, which typically have difficulty raising revenues, and may have significant capacity issues in meeting their new responsibilities.

The new expenditure assignments may also require a significant reallocation of state property among levels of government that could be contentious. As the responsibilities for delivery of services are shifted among different levels, the property that goes along with provision of a service needs to go along with it. Once municipal raions are formed they will need to acquire the schools and clinics necessary for providing these services. Little has been said about how this process will occur.

Assignment of key social welfare provisions to the regional level may exacerbate inequalities among rich and poor regions. A significant aspect of the new laws is the assignment of a large number of social benefit and welfare programs to the regional level. On one hand, this is intended to assist the government in doing away with unfunded mandates. They effectively are passing the responsibility for decision over what social benefits will be provided and how much these benefits should be to the regional level. While the regional level may well have better information than the state level as to what nature of social benefits are required and who is eligible for them, there are two significant issues with this policy. The first is that in assigning such policies to the regional level, those regions that are most in need of social and welfare benefits will be the least able to afford them. Such an approach is bound to increase the disparity that already exists among regions. This is why often such redistributional programs are assigned to the central level of government. A second issue is the degree to which regional governments will actually be able to significantly reduce or eliminate such programs if they do not have the resources.
Politically and socially it will likely be quite difficult to reduce child allowances and social benefits for the disabled. Regional governments are being asked to take on the political costs of doing so, and may determine that this is not possible. They may continue to pay out such benefits, even if sufficient resources are not available, which in turn may lead once again to a build-up in arrears and nonpayments. While the Central Government will be legally justified in arguing that such issues are no longer their problem, it could potentially become a significant political issue. This particular aspect of the new legislation poses significant risks and requires close attention in the coming years.

III. Revenue Assignments Leave Little Autonomy to Regional and Local Governments

The changes in the system of fiscal federalism to date have brought increasing expenditure responsibilities to lower levels of government. The same cannot be said with respect to revenue assignments, another very important component of the system of intergovernmental finance. While there have been significant improvements with respect to revenue assignments since the early 1990s, overall, the approach to revenue assignment and policy remains highly centralized. This is understandable given the crisis of 1998 and concerns of maintaining a stable budget balance. However, such an approach may also undermine the effectiveness of the system of fiscal federalism and reduce the efficient use of public resources.

Recent reforms in taxation and tax policy have largely been focused on the central level, and on assuring the lowering of tax rates and simplification of the system. However, many of the recent tax reforms have implications for subnational governments (Martinez-Vazquez and Timofeev 2003). For example, in 2001 the Federal Government substituted earmarked grants for partial retention of value-added tax (VAT) revenue by regional and local governments. Subnational government turnover taxes, which used to provide a substantial level of own-source revenues for local and regional governments, were eliminated in 2003, and the regional sales tax was abolished in 2004. Effectively, taxes over which regions and/or local governments had some control have gradually been reduced or eliminated, and replaced by earmarked funding by higher-level authorities.

The Law on the Basic Principles of Taxation and the Tax Code determine what taxes can be introduced by the different levels of Government. For example, federal taxes include the VAT, the personal income tax (PIT), the corporate income tax (CIT), the Social Tax (levied on payrolls), excises, customs duties, taxes and royalties on natural resource extraction, and other minor federal revenue sources. However, classification of a tax at one level, does not necessarily determine the level of government that receives the proceeds of the tax. The PIT is a federal tax, but 100 percent of this tax is assigned to regional and local governments. For the so-called “assigned taxes,” revenue sharing

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3 In public finance literature, “own-source” revenues are those over which a government has some control in either determining the base of the tax, the rate of the tax, or both. Thus the government can more effectively be held accountable for both the degree of taxation and how the resources are used.
among levels of government is fixed in the legislation. For the so-called “regulated taxes,” revenue sharing is determined on an annual basis as part of the annual budget process.

The Laws on Regional and Local Self-Governance do not specifically set out proposed tax assignments, but according to the proposed tax bills in the Kozak plan the list of the regions’ own taxes will include the Enterprise Asset Tax and the Gambling Tax. In addition, regional governments will be entitled to a share of the local yield from the following taxes: 17 percentage points of the profits tax rate; 70 percent of PIT revenue and the Presumptive Income Tax; 30 percent of the Small Business Tax, excises on alcohol and on fuel and lubricants, the forestry tax, the water tax, charges on users of wildlife and water bioresources, and the tax on extraction of common resources; and 10 percent of the revenue from the extraction tax on oil.

The Kozak plan also spells out a list of taxes for the new levels of local government, including the Individual Property Tax and the Land Tax (both of which are assigned to settlement governments. In addition, raion/district and settlement governments will be entitled to a share of the local yield from the following taxes: PIT (15 percent to districts, 15 percent to settlements); the presumptive income tax (30 percent to districts, 30 percent to settlements), the agricultural tax (30 percent to districts, 30 percent to settlements), and the small business tax (30 percent to districts, 30 percent to settlements). There is also a proposal that all the revenues for the regional transport tax (levied according to engine power) be allocated to the district level.

On the revenues side there are a number of issues that need to be considered and addressed in order to meet the challenges that will be posed in the future:

There is a significant imbalance with respect to the Government’s approach to fiscal federalism and the expenditure side and revenue side. In order to function well, systems of intergovernmental finance must be treated as a whole, with balance among the various components. Recent developments in the Russian system have been very specific in defining the roles and responsibilities of local governments in the provision of public services, giving them greater independence in the decisions to be made in providing these services (tariff rates, wage rates, and so forth.). At the same time, the system has gone in the other direction with respect to the ability of local governments to determine and manage revenues. Such an approach can lead to a fundamental inconsistency in the system of fiscal federalism by separating the link between public spending and taxation. Limited control over taxation, and dependence on higher levels of government for revenue decisions, provides an easy scapegoat for poor performance or nonperformance of local governments. The accountability of local governments therefore suffers. Interest in the quality and level of local services also diminishes.

Martinez-Vazquez and Timofeev (2003) estimate that as a result of the proposed tax reforms, revenue autonomy will decrease to miniscule levels after 2003—down from own-source revenue of 14 percent of total revenue in the average locality in 2001 to 5
percent after 2003. Local government-assigned revenue shares in total revenue will also fall to 5 percent after 2003. Overall, the share of pre-transfer local government revenue will likely fall from 51 percent to 35 percent of total revenues (Martinez 2003:14). Box 2 suggests how such levels of own revenues compare with international experience.

**Box 2. Revenue Autonomy of Local Governments in Selected Countries**

The already low revenue autonomy of subnational governments in Russia is expected to fall even further as a result of the recent reforms. For an average local government, it is estimated that “own-source” revenue will be approximately 5 percent of total local revenues. This is significantly below that of other countries, be they federal or unitary.

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<th>Percent Own-Source Revenue</th>
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<td>United States</td>
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<td><strong>Unitary Countries</strong></td>
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<td>United Kingdom</td>
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*Source: Martinez-Vazquez, Timofeev, and Boex (forthcoming), Table 5.3. Data for 1995.*

While for reasons of macroeconomic stability and because of the need for new local governments to gain experience, the Central Government may be unwilling to release control over revenues, over time it should consider allowing subnational governments greater control over revenues that are well suited as sources of local revenue. In addition to the property taxes and land tax that have been recently assigned to
settlement governments (but for which the revenue take will be low for several years until the necessary systems are developed), the government might consider allowing regional and local governments a “piggyback” on the personal income tax. This tax should eventually be paid by place of residence, and local governments should be given discretion to set a rate between a minimum and maximum band legislated by the Federal Government. Another option for providing additional autonomy over taxes is to allow regions and large localities to place local surcharges on excise taxes on items with inelastic demand, such as alcohol, tobacco, and petroleum.

Continuous monitoring and oversight will be required to assess how revenue assignments match up with expenditure assignments. Local government expenditure responsibilities are considerable under the new proposals, and it appears the new revenues assignments may not fully close this gap. In addition, higher-level governments are required by the legislation to finance delegated functions, but in practice this has been a problem in the past. It will be critical to keep a close watch on how local revenues match up to local expenditures to assure that this balance does not become untenable, and that where there are significant gaps, they are being addressed through the transfer system.

The application of similar taxes to very different environments is likely to lead to very different outcomes. The revenue assignments proposed to date suggest little flexibility for tax assignment based on different types of localities. The same assigned taxes are meant to apply to all governments at a given level. This could potentially become an issue at both the district/raion level and at the settlement level. The taxable bases and activities between urban districts and municipal raions are likely to be quite different, and also to vary across the country. The same issue will be faced by municipal settlements and rural settlements. This is again an area where allowing local governments some degree of discretion in choosing local revenue instruments may have been worthwhile.

IV. Building on the Transfer System

As seen above, revenue assignments in Russia are not well matched with expenditure assignments, which lead to “vertical imbalances” in the system. Fiscal disparities also exist across subnational jurisdictions as a result of the great variation in revenue bases and economic strength of different localities. A critical component of any system of intergovernmental finance is the system of transfers that is used to address these imbalances and to at least aim for a system in which all governments have adequate resources to provide a basic set of services.

From the mid-1990s a great deal of attention has been paid to the development of the federal–regional system of transfers. Figure 3 shows the magnitude and composition of federal grants to the regions since 1992.

4 Vertical imbalances exist when the revenue sources assigned to each level of government do not correspond to their expenditure responsibilities.
Figure 3. The Composition of Federal Grants to the Regions Since 1992

Clearly, the overall magnitude of transfers has ranged from a peak of almost 3.5 percent of GDP in 1994 to just under 1.5 percent of GDP in 1999. In 1994 the creation of the Federal Fund for the Financial Support for the Regions introduced a formula-based system for allocating resources to regional levels of government based on an assessment of expenditure needs and revenue capacity. The overall size of the equalization pool is set as part of the annual budget process. Although the formula is used to determine the shares allocated to individual regions, in practice the legislated amount may differ as a result of bargaining in parliament, especially over the particular weights to be used in the formula.

In 2001, the Compensation Fund was created to provide earmarked grants to subnational governments in order to finance the federal mandates on child welfare and on assistance to the disabled. These resources are allocated on a per capita basis of those meeting the child welfare and disabled assistance criteria. In 2002, the Regional Fiscal Reform Fund (financed by the World Bank) was created to allocate incentive-based grants to regions successfully implementing a program of fiscal reforms. The allocation is also based on a formula.

Other grants and loans have increased considerably in recent years. These include: social expenditure grants, which are matching grants aimed at funding specific key regional social expenditures, and regional development grants, which are specific-purpose grants to finance regional public investment in infrastructure. In addition, there are numerous other grants and loans that are allocated on a discretionary basis. In 2004 these include allocations for the following: repayment of the debt to the Federal Government for transferred housing; a stabilization subsidy; liquidation of the
consequences of natural disasters in agriculture; additional financial assistance for road construction; subsidies to regions in which the increase in public sector wages (mandated by the center) was a substantial expenditure line item; and other subsidies of unspecified purpose. The increase in these more discretionary and less transparent “other grants and loans” is of considerable concern.

Over the years, less attention has been paid to the system of transfers within the regions. Regions have tended to use an approach that relies on filling the gap that results between expenditure responsibilities and revenues by adjusting tax-sharing rates. The new laws introduce the notion of uniformity of tax-sharing rates among local levels of government as opposed to the old system of “regulatory taxes.” This helps to improve the transparency and predictability of the system by making it clear a priori how much of a particular tax will be shared with a region and providing the basis for new transfer systems. However, there appear to be important ways of getting around this uniformity.

The reforms propose to put into place two equalization funds at the regional level: one for the urban district/municipal raion level and one for the settlement level. These equalization funds are to be formula based, drawing on assessments of the expenditure needs and fiscal capacity of a given level of government consistent with what will be set out in the Budget Code. However, Article 60 of the law on local self-governance also states that equalization subsidies can be replaced by establishing additional tax-sharing standards. These will be determined each year in the annual budget for the region. The regions may also delegate equalization of settlements to the municipal raions, provided that the region also delegates the required resources. Raions will also have funds for supporting the equalization of the settlements based on a similar approach.

The system proposed at the regional and district/raion level also introduces the notion of a “negative transfer.” If the budget capacity of a settlement, district, or raion exceeds by two or more times the average for the given level of government within the region, the law provides that the local government may be required to provide subventions to the equalization fund. Such a subvention would not exceed 50 percent of the total difference between the total revenues of the settlement, district or raion counted in the projected budget capacity in the formula, and two times the average budget capacity of the settlements in the region for the last reported year. In cases of noncompliance, the region is entitled to retain a portion of the revenues from the collections of local taxes and assessments and/or reduce tax-sharing standards for receipts of federal and regional taxes.

In addition to the equalization funds, the regions will have a Regional Compensation Fund to provide funds for state responsibilities delegated to lower levels of government. Sources of funding for the Regional Compensation Fund come from the Federal Compensation Fund and other budget revenues of the region, and its implementation will be guided by the Budget Code and a regional law.

Regions may also create a Municipal Development Fund to allocate subsidies to municipalities for co-financing of investment programs and development of local public
infrastructure, a Regional Fund for Co-Financing Social Expenditures in order to co-finance priority social expenditures in the municipal budgets, and other financial assistance funds consistent with the Budget Code.

Effectively, the reforms by and large replicate at the regional level the transfer system that is currently in place at the federal level. The only exception is the creation of two equalization funds at the regional level—one for settlements and one for municipal raions/urban districts. Such an approach is unlikely to improve transparency and predictability of the system for local governments, especially in regions that continue to rely on adjustment of tax shares to deal with equalization problems. The funds for support of the settlements and for municipal raions and urban districts should in theory address the disparities across levels of government (horizontal imbalances), while the proposed compensation fund should help address the vertical disparities that exit within the system. However, the proposed reforms to the transfer system also raise a number of issues that will need to be addressed as the system is implemented:

The proposed system may not provide the transparency and predictability that are essential for a transfer system to work well. The reforms put in place a fairly complicated structure of transfers. Two equalization funds (one at the regional level and one at the raion level) are meant to address disparities among the settlements. How these will fit together is not entirely clear. Nor is it clear how the equalization funds for settlements and for municipal raions/urban districts will operate together.

In establishing transfer systems, it is ideal to identify the source of funds for financing the transfer mechanism, and the methodology for allocating resources among levels of government. The proposed changes do this in some cases (funds for the Regional Compensation Fund will come from the Federal Compensation Fund and regional revenues), but not in others (the source of revenues for the multiple equalization funds is not clear). With regard to the allocation of resources, the general principals of per capita allocation for a given service and fiscal capacity are proposed throughout, but the specifics are left to the relevant regional law, which must be in conformity with the Budget Code. However, the Budget Code does not apply a specific type of formula, and even the formula at the central level has been the subject of bargaining. Similar behaviors are likely to be even more serious at the regional and municipal level, if the formula for the equalization transfers is not explicitly stated and enforced.

An additional source of uncertainty and a potential lack of transparency resides in the option that regions have to employ “additional tax-sharing” standards in lieu of actual equalization subsidies. This is in contradiction to the law’s claim that all tax sharing should be carried out on a uniform basis, and effectively provides the option of going back to adjustment of tax-sharing rates to manage equalization. This latter approach is the tradition in most of the regions, and is based on the effectiveness with which local governments can negotiate with the regional government. If this option is one chosen by regions, then equalization transfers could remain “negotiations based,” and would not support the transparency and clarity needed for the system to function well.
Significant further work is needed to specify and clarify the formulas to be used at the regional and raion level, and to estimate the overall impact on equalization of the implementation of the proposed system of transfers.

The proposed system implies a significant shift for localities away from tax-based sources of revenue to earmarked transfers, implying a further decline in discretion over their budgets. An important component of the reforms is to assure that all delegated functions are specifically financed. While this approach helps to address the problem of unfunded mandates, it creates an issue with respect to the autonomy and discretion of local governments. A result of the earmarked financing of mandates will be the concentration of subnational budgetary funds in regional budgets. A substantial proportion of funds that had been assigned to municipalities in the form of tax revenues will first have to be entered into the regional budget, and only then transferred to localities through earmarked transfers. It is estimated that the share of earmarked transfers in local budget revenues will increase from 9 percent to 40 to 50 percent of revenues (Kurlyandskaya 2004a:39). Such a shift will inevitably reduce the discretion of localities over their expenditure, since earmarked funds are tied to particular types of expenditures. It will be critical that these earmarked funds are not so tightly defined that localities have no room for decisions over how best to deploy resources in the delivery of key services such as education.

The implementation of the proposed system of transfers is likely to require both data and capacities that some regions and local governments do not have. Implementation of the reforms as a whole will stretch regional, municipal/urban, and settlement governments, but the implementation of the proposals on the transfer system are especially difficult. Management of several transfer systems requires a certain degree of expertise and knowledge: some regions clearly have already established this, but a good number have not, and will strongly favor continuing with the approach they currently use. In addition, the implementation of the various transfer mechanisms will require data on expenditure needs per person, and on fiscal capacities at the different levels of government. The Law on the General Principles and Organization of Local Self-Governance specifies that actual revenues and expenditures cannot be substitutes for the projected budget capacities, so local governments will have to work through a methodology that is consistent with regional legislation on how to do this. Many may not have the information easily at hand. Information will also be needed to determine the amount of resources required from the compensation fund. Equally important will be the ability to monitor this data and implementation of the transfer mechanisms to assure that allocations are in fact consistent with the agreed methodology. The regional and local governments will need considerable assistance if they are to implement the system of transfers so that it functions as it should.

It is clear from the Kozak proposals and the recently approved laws that the system of fiscal federalism in Russia is about to undergo significant change. The structure of local-level governments will be systematized across regions and given considerable new responsibilities. At the same time, the revenue structure and system of transfers will shift control of resources away from local government to the Federal and regional...
governments. These changes will help the government meet some of its objectives, but they will also continue to pose considerable challenges, especially with respect to the autonomy of local governments and the support that will be required for implementation of the reforms.
References


