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Fiscal Federalism in Russia

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Intergovernmental Fiscal Relations in the Russian Federation

Roy Bahl and Christine I. Wallich

The Russian Federation is facing a difficult period of economic and political transition.¹ It is attempting to restructure its economic system, protect the well-being of its citizens, stabilize prices and its external balance, and provide public services to support social and economic development. At the same time, it is seeking to establish a system of governance acceptable to regions whose cultural identities, natural resource endowments, and degree of economic development differ widely. The reform program is bold—it includes industry privatization, price liberalization, financial sector modernization, agriculture reform, and tax system reform. These reforms will significantly change the government's role in the economy, reducing its control over financing and the allocation of resources while strengthening the regulatory and other functions characteristic of governments in market economies.

These reforms have changed the responsibilities of all levels of government—from the federal parliament to the village soviet—including governments' expenditure responsibilities, revenue needs, and the tax bases available to collect revenues. The Russian Federation also has ambitious plans for fiscal reform and has introduced several changes in the revenue and expenditure system at the federal level. Fiscal reforms will play an important role in the success of Russia's reform effort. First, sound fiscal policies are critical to a successful stabilization effort. Second, the equity and incentive aspects of tax policy support structural reforms by creating an environment in which the private sector can flourish. Third, expenditure reform has given subnational governments important new responsibilities for a new, more targeted social safety net and for infrastructure investment.

The Russian Federation is also reconsidering some basic issues in intergovernmental finance: the division of expenditure responsibilities and the assignment of revenues between the federal government and Russia's oblasts (the equivalent of a state). It is considering a system of transfers that will both finance the revenue shortfall of subnational governments and support a more efficient and equitable provision of government services across oblasts. Unlike tax reform, policy changes in intergovernmental relations and subnational finances have just begun and are less well developed. The scope and form these changes take will affect both the political character and the economic stability of the Russian Federation, with significant consequences for the efficiency with which the economy performs.

This chapter discusses the context and evolution of Russia's fiscal system, its expenditures and expenditure assignment policies, the current tax and intergovernmental system, and options for reform. The following chapter (chapter 10) discusses the divisive issue of sharing natural resource tax revenues and the demands being made by certain oblasts for special fiscal treatment within the Russian Federation.

Intergovernmental fiscal relations: Setting the stage

The Russian Federation is the largest and one of the most diverse countries in the world, with regions whose cultures, politics, ethnicity, and resource endowments vary widely. This diversity presents a challenge to effective administration, budgetary management, and stabilization and structural policies.

Basic characteristics of Russia's administrative and federal structure

The Russian Federation is a three tiered federal state consisting of eighty nine provinces or states directly subordinate to the federal government and known as "subjects of federation." These states comprise the oblasts, okrugs, krais, autonomous regions, national regions, metropolitan cities with oblast status (Moscow and St. Petersburg), and, until mid-1992, the autonomous republics (now, merely republics).² They are collectively referred to as "oblast level" or "subnational" throughout this chapter. The Russian phrase "subnational administrations" indicates their lack of substantive powers under the previous regime. Below the oblast level governments are the municipalities and rayons, local governments that are subordinate to the oblast governments (see map of the Russian Federation, facing page 324).

Even when they were still part of the U.S.S.R., and until the constitutional changes of 1994, some republics had their own governments, called Supreme Soviets, which had some degree of autonomy. Immediately after the breakup of the Union, some republics declared independence from the Russian Federation. These declarations have not been recognized by the Parliament of the Russian Federation or by any other country.

The Federation Treaty of 1992 continued the process of defining the relationship between the federal government and the eighty-nine oblast-level units, but did not complete it. The treaty confirmed the greater role of the ethnic republics over their foreign policy and foreign trade relations with the federal government and over their relations with other republics, krais, and oblasts (World Bank 1992c). Traditionally, metropolitan cities, krais, and autonomous okrugs have had more autonomy from the federal government than the other oblasts—but less autonomy than the republics. The republics of Chechnya and Tatarstan refused to sign the treaty, and Chechnya is currently at war with the Federation over its status. Under the new Constitution, all oblasts have equal status, and there is no formal differentiation among the subjects of the Russian Federation, despite pressures to create it (see chapter 10).

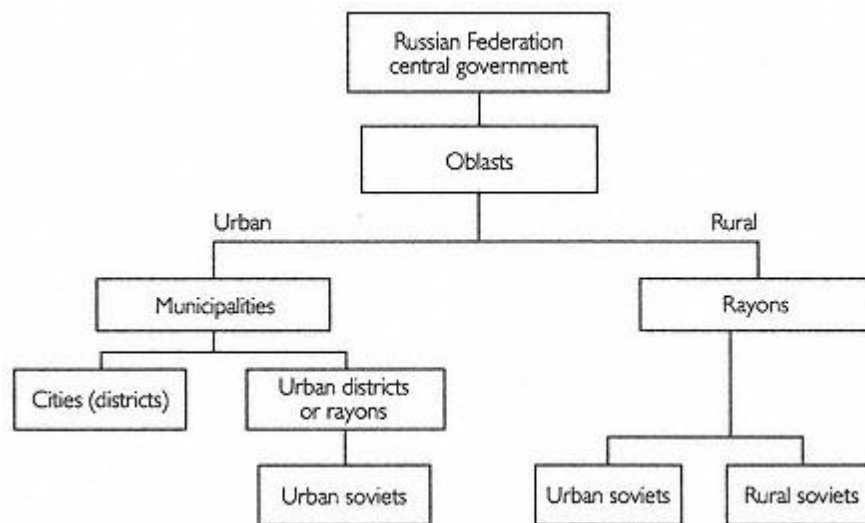
All of Russia's eighty-nine administrative divisions except Moscow and St. Petersburg are further divided into rayons, or districts. The roots of these administrative divisions are in the four-tiered structure of the former Soviet Union, which comprised the Union government, fifteen Union republics, oblasts, and cities or rayons (IMF 1992b). In the Russian system, the central government interacts directly only with oblast-level governments.

Russia's administrative structure.

Each oblast supervises urban and rural areas within its jurisdiction (figure 9.1). All local governments within an oblast report to the oblast government and carry out duties according to oblast regulations. For example, at the end of 1993 the Moscow oblast contained sixty cities with populations ranging from 60,000 to 200,000 and 650 independent rayon, city, and rural settlements. Each oblast has an independent (that is, separate and free-standing) budgetary and administrative status. Although the oblast-level finance departments are by law autonomous and the formal subordination of oblasts'

finance departments to both the central Ministry of Finance and the oblast administration has been eliminated, finance officers are paid by the central government budget. Oblast finance departments may thus feel competing loyalties to the center and to the oblast government and respond to competing realms of authority or, in Russian parlance, “dual leadership” (figure 9.2). While formally they act as deconcentrated arms of the central administration, incentives to respond to local policy concerns still exist.

Figure 9.1



Government structure, Russian Federation, 1994

Note: In some oblasts urban rayons may be directly subordinate to the oblast government. Oblast refers to all “subjects of federation.” Solid line indicates subordination.

Source: Wallich 1994.

Under Russia’s new system of budgetary legislation each level of government now prepares its own budget. The system is based largely on sharing of federal taxes (see below). Although federal-oblast tax-sharing rates are in principle fixed by the state Duma (Parliament), in practice they are negotiated with the Ministry of Finance and are designed to give the oblasts sufficient revenue while also providing adequate funding for the federal budget. Thus, the Russian intergovernmental system is not really a system, but a series of ad hoc negotiated arrangements whose effects and incentives are not well understood.

Another unusual characteristic—compared with other systems of federal finance in market economies in which the central government collects most tax revenues and shares them with lower levels—is that revenues in the Russian system are collected at the oblast and rayon level and “shared up” (similar systems exist in other former Soviet republics and in China and Viet Nam). The breakdown of this upward sharing system in 1991, when the Union republics ceased making transfers to the U.S.S.R. budget, contributed to the dissolution of the Union. A similar threat could hang over the Russian Federation unless these issues are resolved (see chapter 10).



1. Arkhangel'skaia oblast
2. Nenetskiĭ autonomous okrug
3. Republic of Karelia
4. Republic of Komi
5. Murmanskia oblast
6. Volgodarskaia oblast
7. St. Petersburg
8. Leningrad'skaia oblast
9. Novgorod'skaia oblast
10. Pskov'skaia oblast
11. Briansk'skaia oblast
12. Ivanov'skaia oblast
13. Kaluzh'skaia oblast
14. Kostrom'skaia oblast
15. Moskvo'skaia oblast
16. Moscow City

17. Orlov'skaia oblast
18. Riazan'skaia oblast
19. Smolensk'skaia oblast
20. Tversk'skaia oblast
21. Tul'skaia oblast
22. Vladimir'skaia oblast
23. Iaroslavl'skaia oblast
24. Republic of Chuvash
25. Kirov'skaia oblast
26. Republic of Marii-El
27. Mordovian Republic
28. Nizhniĭ Novgorod oblast
29. Belgorod'skaia oblast
30. Kursk'skaia oblast
31. Lipetsk'skaia oblast
32. Tambov'skaia oblast

33. Voronezh'skaia oblast
34. Astrakhan'skaia oblast
35. Republic of Kalmykia
36. Penza'skaia oblast
37. Samarsk'skaia oblast
38. Saratov'skaia oblast
39. Republic of Tatarstan
40. Ulianov'skaia oblast
41. Volgograd'skaia oblast
42. Republic of Dagestan
43. Chechen Republic
44. Kabardino-Balkar Republic
45. Krasnodarskii krai
46. Republic of Adygeya
47. North-Osetian Republic
48. Rostov'skaia oblast

49. Stavropol'skii krai
50. Karachai-Cherkess Republic
51. Republic of Bashkortostan
52. Cheliabinsk'skaia oblast
53. Kurgan'skaia oblast
54. Orenburg'skaia oblast
55. Perm'skaia oblast
56. Komi-Permyatsk'skaia autonomous okrug
57. Sverdlovsk'skaia oblast
58. Udmurt Republic
59. Altai'skii krai
60. Republic of Altai
61. Kemerov'skaia oblast
62. Novosibirsk'skaia oblast
63. Omsk'skaia oblast

64. Tomsk'skaia oblast
65. Tyumen'skaia oblast
66. Khatyn'-Mansiiskii autonomous okrug
67. Yamal-Nenets autonomous okrug
68. Republic of Buryatia
69. Chitinsk'skaia oblast
70. Aginskii Buryatskii autonomous okrug
71. Irkutsk'skaia oblast
72. Ust'-Ordynskii Buryatskii autonomous okrug
73. Krasnoiar'skii krai
74. Republic of Khakasia

75. Taimyrskii (Dolgano-Nenetskii) autonomous okrug
76. Evenkiiskii autonomous okrug
77. Republic of Tuva
78. Amurskaia oblast
79. Kamchatskaia oblast
80. Koriakii autonomous okrug
81. Khabarovskii krai
82. Jewish autonomous oblast
83. Magadansk'skaia oblast
84. Chukotskii autonomous okrug
85. Primorskii krai
86. Sakhalinsk'skaia oblast
87. Republic of Sakha (Yakutia)
88. Kaliningrad'skaia oblast
89. Ingush Republic

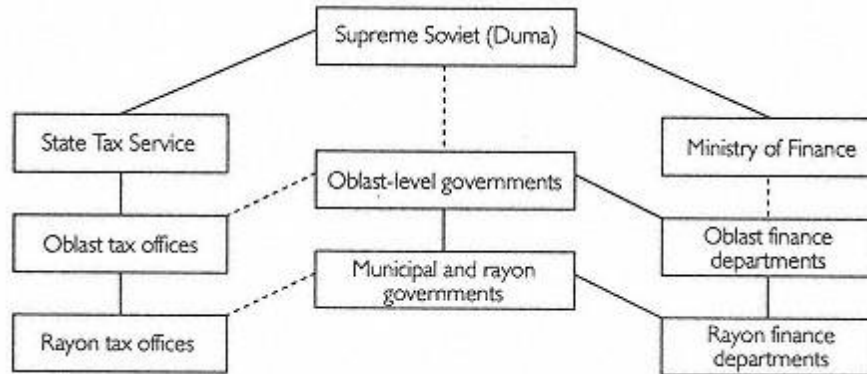


Figure 9.2

Hierarchy of government administration and finance, Russian Federation, 1994 Note: Solid line indicates subordination; dashed line indicates supervision.

Source: Wallich 1994.

Basic characteristics, geography, and nationalities of the Russian Federation

In 1991 Russia's population of some 150 million accounted for 51 percent of the total population of the Soviet Union. The Russian Federation itself includes dozens of ethnic groups. About 82 percent of the population is ethnically Russian. Other major nationalities include Tatars (3.8 percent), Ukrainians (3.0 percent), Belorussians (0.8 percent), and Germans (0.6 percent). Others include Jews, Armenians, and Kazakhs (each 0.4 percent), Bashkirs, Yakuts, Osetians, and Chechens. Many of these nationalities are geographically concentrated, although they do not represent majorities in many of these regions (see chapter 10, map of the non-Russian population in the Russian Federation, facing page 382).

Nationality-based administrative units cover about half the geographical territory of the Russian Federation. The European part of the country is relatively densely populated and includes Moscow, with 9 million inhabitants, and St. Petersburg, with 5 million. The Asian part is more sparsely populated, with major urban centers in the Urals and along the Trans-Siberian Railroad.

With an area of 6.5 million square miles spanning eleven time zones (from Kaliningrad on the Baltic Sea to the Bering Straits by Alaska), the Russian Federation covers one-eighth of the world's land surface, making it the largest country in the world. With the exception of the Central Asian deserts, the Russian Federation retains all the major geographical features of the former U.S.S.R. The northernmost part of the country is arctic desert and tundra. Two-fifths of the territory is permafrost. South of the tundra stretch forests (the taiga) and farther south lie the steppes.

Resource endowments across regions

The Russian Federation has vast natural resources (see chapter 10, map of the natural resource endowments of the Russian Federation, facing page 390). Its large mineral deposits include coal, oil, phosphorites, natural gas, potassium salts, and iron ores, as well as gold, diamonds, copper, lead, tin, bauxite, manganese, silver, molybdenum, graphite, nickel, uranium, and rare metals. Some of the most important oil and mineral deposits are located in republics and ethnic regions. For example, a large part of the western Siberian oil fields is in the territory of the Khanti-Mansisk autonomous okrug and the

Yamal autonomous okrug. Together these two oblasts produce 80 percent of Russia's oil and gas and 20 percent of the world's supply. Important oil fields are also in Tatarstan. Major diamond deposits are located in the Yakutia Republic, which produces 99 percent of Russia's diamonds and 25 percent of the world's supply.

These resource endowments are reflected in Russian average wage incomes, which vary widely across oblasts. In 1992 the two richest oblasts, Magadansk and Tyumen (which until 1991 contained the oil-producing Khanti-Mansisk autonomous okrug), had average wages exceeding 28,000 rubles, almost ten times that of the poorest, the Dagestan Republic. Budgetary disparities are also significant: per capita expenditures in 1994 range from 83,665 rubles in the diamond rich Sakha (Yakutia) Republic to 5,077 rubles in the Chechen Ingush Republic. Differences are also vast in other areas of well being—education levels, morbidity, housing, access to medical care—and even greater in so called national economy expenditures such as capital investment and food subsidies. For example, some oblasts spend more than ten times as much as others per capita on education and health and only 40 percent as much as others on national economy expenditures (Le Houerou 1994).

Inflation rates also differ greatly throughout the Russian Federation, implying that money wages and expenditures do not reflect purchasing power. The Chechen-Ingush Republic, one of the poorest localities in money wage terms, suffered the least from inflation in 1992. The highest level of inflation that year was in Primorski krai, where the inflation rate of 1,726 percent was more than twice that of the lowest (Le Houerou 1994). These differentials persist because high transport costs and administrative supply constraints prevent the free movement of goods and services. These high inflation rates and a scarcity of goods and services have led to poverty in many of the resource-rich areas, despite their high nominal wages.

Expenditure assignment

The design of intergovernmental fiscal policy should always begin with the expenditure side. First: Which level of government will deliver which services?ⁱⁱⁱ Then: What level and kind of government financing are implied? Issues that arise in connection with expenditure assignment in Russia include whether the current division of spending responsibilities matches best principles, the implications of the current movement toward expenditure decentralization for the robustness of the social safety net, and whether the limited budgetary autonomy of subnational governments poses special problems.

Division of expenditure responsibility

The most basic issue associated with expenditure assignment is the division of spending responsibilities. What are the key functions of government, and which level of government should carry out which functions? There is no best system of expenditure assignment or service decentralization. Local preferences, household mobility, economies of scale, spillover effects, and political considerations suggest what will be feasible for a particular country. A well-designed intergovernmental system should be able to adapt to changes in preferences and to changes in the relative importance of efficiency, equity, and stabilization objectives. International experience shows that stable systems of intergovernmental relations are characterized by clearly stated expenditure assignment rules, rather than by the subjective decisions and murky assignments that define the intergovernmental system in Russia (see chapter 1).

How consistent are Russia's spending assignments with principles?

Formally, Russia does not define or allocate legally the expenditure responsibilities of its federal, oblast, and rayon governments. Rather, tradition and inertia have led to “accepted” spending assignments that until recently have been observed as relatively stable over time. Thus, spending responsibilities are established (or reestablished) in each annual budget (or more recently, quarterly budget), which serves as the vehicle by which spending authorities are codified. Since Russia has explicitly assigned revenues between levels of government, this puts the cart before the horse: subnational spending decisions are being revenue-driven, rather than revenues being expenditure-driven.

The traditional assignment of public service activities in Russia to different levels of government is based on the principle of assignment according to the geographical dimension of benefits. This economic efficiency rule was inherited from the former Soviet Union. Thus, the central government provides public service activities whose benefit area encompasses the entire nation. Public services with a regional dimension, such as universities and tertiary and psychiatric hospitals, are provided by the oblast level of government. Those with a local dimension, such as elementary schools and parks, are provided by rayon and city governments (table 9.1).

Almost all the former U.S.S.R.'s Union-government-level spending functions have been assumed by the Russian Federation. The federal budget is responsible for large and important enterprises (so-called group A), including pipelines, electric power, marine transport, and national environmental problems (such as the Chernobyl accident, which has had major consequences for Russia, although the reactor was located in Ukraine). The federal government is also responsible for inter-national trade activities and fundamental science. In the social sectors, the federal budget accounts for a small share of financing for universities and other higher level learning institutions, specialized health care facilities, and cultural affairs including museums, in keeping with the principle of minimizing federal involvement when the “benefit zone” is local or regional.

The oblast level has traditionally been responsible for spending of an interjurisdictional nature covering two or more rayons within the oblast. Examples are river transport, oblast roads, environmental issues at the oblast level, forest preservation, vocational schools, intermediate health care at oblast hospitals, and specialized clinics. Oblasts and republics are also responsible for small and medium-size enterprises such as local light industry and consumer goods. Oblasts are increasingly transferring such enterprises to the rayon level to avoid paying the subsidies needed to support them. The expenditure responsibilities of rayons and townships are concentrated in the social services area. Rayon budgets account for almost 100 percent of basic education expenditures, 85 percent of health expenditures, 80 percent of public utility expenditures, 60 percent of kindergarten services, and 60 percent of housing expenditures (Wallich 1994; Le Houerou 1994).

Although this basic and traditional assignment of spending responsibilities has generally matched assignment according to benefit area, the actual practice in recent times does not. Specific service responsibilities are not clearly assigned to specific levels of government, and no laws govern expenditure responsibilities, a striking contrast to the precision with which revenues have been assigned. This murkiness has led recently to some cases of service provision by more than one level of government or to service provision at the wrong level (see below). In addition to traditional public service functions of government, the assignment of responsibilities in Russia includes ownership of certain commercial and

industrial enterprises and all the expenditure responsibilities related to ownership, a practice that significantly complicates expenditure assignment.

Table 9.1 Expenditure assignment by level of government, Russian Federation, 1992–93

<i>Expenditure</i>	<i>Federal</i>	<i>Oblast</i>	<i>Rayon</i>	<i>Village soviet</i>
Defense	100 percent	Some military housing	None	None
Justice and internal security	100 percent	None	None	None
Foreign economic relations	100 percent	None	None	None
Education ^a	<ul style="list-style-type: none"> • All university and research institute expenditures • All technical and vocational schools 	Several special vocational schools	Wages Operation, construction, and maintenance of all primary and secondary schools	None
Culture and parks ^b	<ul style="list-style-type: none"> • National museums • National theater 	Some museums with oblast significance	<ul style="list-style-type: none"> • Some museums • All recurrent expenditures of all sport and park facilities and all other cultural facilities 	None
Health ^c	Medical research institutes	Tertiary hospitals, psychiatric hospitals, veteran hospitals, diagnostic centers, and special service hospitals (such as cardiology)	<ul style="list-style-type: none"> • Secondary hospitals • Primary health clinics • Medicine 	Paramedics
Roads ^d	<ul style="list-style-type: none"> • Construction of federal roads • Maintenance of oblast roads 	Maintenance of federal roads	Maintenance of rayon and city roads	Maintenance of commercial roads
Public transportation	Previously interjurisdictional highways and air and rail transport	Most public transportation facilities	Some transportation facilities, including subway systems	
Fire protection ^e	None	<ul style="list-style-type: none"> • Most fire protection services 	Voluntary, military, and enterprise services possible at this level	

Libraries	Special libraries (such as the Lenin library)	Special library services	Most local library services	
Police services	National militia	Road (traffic) police	Local security police	
Sanitation (garbage collection) ^f	• None	• None	• Part of garbage collection	• Part of garbage collection
Sewerage ^g	• Infrastructure capital investment	• Most operational expenditures	• Some operational expenditures •	None
Public utilities (gas, electricity, and water)	• None	None	• None	• Subsidies to households (not enterprises)
Housing ^h	• Building and development	• None	• Maintenance and small scale building	None
Price subsidies	None	None	• Fuels, mass transport, food (bread, milk), and medicine	None
Welfare compensation	• Partly central responsibility	• Partly oblast responsibility	• Managing programs funded by upper-level governments	None
Public enterprises (productive sectors)	None	Capacity to invest in joint ventures (keeping 50 percent of privatization proceeds if there is rayon subordination)	•Capacity to invest in joint ventures (keeping 50 percent of privatization proceeds if there is rayon subordination, and 10 percent if any other subordination)	None
Environment	National environmental issues	• Local environmental problems (such as forest preservation)	None	None
Enterprises	• Group A enterprises (such as transport and heavy industry) •Group B enterprises (such as transport, light industry, and agriculture)	•Group C enterprises (such as light local industry, housing construction, and food industry)	•If transferred to local level	None

Note: Capital expenditures are included unless otherwise noted

a. Public enterprises also build schools but typically do not operate them. They frequently operate kindergarten services.

b. Some enterprises build sport facilities.

c. Some enterprises build hospitals and in some cases operate them. Social insurance, financed primarily by enterprises, pays for the health services of those

- d. covered.
 - e. A “special extrabudgetary fund” is financed by an excise tax on oil consumption.
 - f. Special fire protection services are provided by enterprises, but such provision is declining.
 - g. Separate user charges do not normally apply for garbage collection.
 - h. Separate user charges apply for sewerage.
 - i. Enterprises have been important builders of housing and own nearly half of the housing stock in Russia. The central government has transferred housing to local governments; maintenance is the responsibility of the level of government or enterprises owning them.
- Source:* Updated from Martinez-Vazquez in Wallich (1994).

Shifting central spending functions downward

Recent changes in the assignment of expenditure responsibility have violated benefit-area principles in fundamental ways. An important part of social, and most capital, expenditures has been delegated to the subnational level. However, the new revenue-sharing system to the subnational level has not taken these new responsibilities into account. For example, in early 1992 the central government shifted responsibility to the oblast and rayon governments for most price subsidy and income maintenance programs. Previously, these had been administered by the oblasts but financed with transfers from the central government equaling about 5 percent of gross domestic product (GDP). While the direct burden of price subsidies ceases after prices are freed, the underlying problem of financing social protection for those most hurt by economic change does not. The central government has not estimated the cost of financing this social protection, nor has it developed a way to match this cost with each oblast's available revenues.

Until recently the federal level was responsible for approving, financing, and implementing all subnational capital investment. In mid-1992 national investment responsibilities, such as highways, military housing, and airports, as well as those with local significance, were shifted to subnational budgets. It appears that the main rationale for the reassignment was to balance the central government budget and to claw back the apparent surpluses of subnational governments, which were thought to have been created by the introduction of a new revenue-sharing system in early 1992. The shift placed serious budget pressures on some subnational governments, creating the risk that important social expenditures such as health care and education would be crowded out. Although shifting these spending responsibilities down to lower-level governments may have helped the center's short-run budget pressures, it is inconsistent with expenditure assignment principles and will inevitably lead to distortions and a repressed deficit at the subnational level, with needed but postponable spending not undertaken, or with recourse to other quasi-fiscal financing.

Realizing some of these problems, the center took back control over expenditures on federal highways and much of military housing in late 1992. Although probably a good move, assigning and reassigning expenditures in this manner creates its own set of problems, especially with regard to predictability of subnational expenditures and their revenue requirements.

A more general issue is the absence of concreteness in assigning spending responsibilities. Both subnational and central governments reap advantages from the continued ambiguity. Subnational governments use their broader responsibilities to bargain for a larger share of revenue, and the federal government has an additional instrument to balance its own budget—jettisoning expenditure

responsibilities to lower-level governments. This lack of definition cannot continue if the system of intergovernmental relations in the Russian Federation is to move away from bargaining and toward greater certainty and predictability. If expenditure responsibilities are not clearly assigned, it will be impossible to determine the revenue sufficiency of alternate financing arrangements.

More important, if this trend persists, what important expenditure functions will the central government perform to justify its existence to skeptical regional governments? By eschewing the concrete assignment of responsibilities, the federal government may inadvertently be contributing to its worst fear—the disintegration of the Russian Federation (Martinez Vazquez 1994b).

Expenditure autonomy

To realize economic efficiency, subnational governments must have discretion in making budget decisions. Even though the Law on Budgetary Rights of Local Self- Governments (June 1993) prescribes full autonomy, the budgetary activities of Russia's subnational governments are constrained in several ways. Since the central government dictates the center-oblast tax-sharing rates and defines the rate and base of all central and local taxes, subnational governments cannot determine autonomously the aggregate size of their budgets. Thus, there are no truly independent sources of oblast or rayon revenues. Among other constraints are the unfunded central spending mandates that govern many subnational expenditures. For example, the federal government determines wages for all public employees and prescribes the rate of wage increases. The federal government also sets ceilings on several public sector prices, notably tariffs on many forms of public transport and utilities.

Pensions and wages for teachers and health providers are also centrally mandated. Rents on housing owned by enterprises and local governments were controlled until mid-1992.

In earlier years subnational government budgetary discretion was constrained by thousands of budgeted capacity norms used to determine the financial requirements for each subnational expenditure item. These norms translated minimum physical quantities into ruble amounts and were used to determine the costs of operating existing facilities (box 9.1).

Box 9.1 Health sector expenditure norms in the Russian Federation

Expenditure norms for most expenditure items in the social sphere of the budget exist at each level of government. The norms for the health sector are released by the ministries of finance and health. They include detailed standards for the cost of each part of the health care sector's operations and outlays, including cost standards for the acquisition of beds and uniforms, for physicians' visits, for the acquisition of medicine, and so on. The standards differ according to the specialization of the hospital or hospital department. The following is an example of the cost standards for one patient's food ration per day at each of the seventeen types of health institution:

<i>Type of patient/hospital</i>	<i>Budgetary norm per capita per day (rubles)</i>
Children	7.00
Maternity	7.00
Infants	1.00
Gynecology	5.60
Gastroenterology/hematology	5.60
Necrology	5.40
Leprosy	4.71
Pneumoconiosis	4.71
Oncology	3.89
Endocrinology	5.18
Burn	4.56
Tuberculosis	4.71
Children's tuberculosis	5.18
War invalids	6.48
Daytime inpatient	3.89
Unpaid blood donors	3.91
Paid blood donors	1.71

For example, norms would determine the ruble amount needed to maintain an existing hospital bed. By 1993 inflation had rendered the expenditure norms useless in determining the required financial outlays. Subnational governments are still bound by salary schedules and some physical mandates on numbers of employees and levels of service, but otherwise have discretion on the mix of expenditures.

Under this system of expenditure norms, the food budget of an oblast hospital, for example, was calculated using the per capita daily food

expenditure norms for each of seventeen different patient/hospital categories—a tuberculosis patient was allotted 4.71 rubles (in 1991) for food, while children and maternity patients received the maximum allowance of 7 rubles, and infants were allotted only 1 ruble a day. Each category's ruble amount (expenditure norm) was then multiplied by the corresponding expected number of patient-days per year to determine the food needs of the ward or specialized hospital. Total hospital budgets were calculated as the sum of the various norm-determined service costs for all patients, which included such things as medicine, physicians' visits, and even linen changings for each class of patient. Thousands of such norms for each spending category were issued by the Ministry of Finance and the specialized ministries under the old system.

Price liberalization since 1992 precluded establishing norms. Rather, physical norms were costed out by asking each locality to estimate the cost of providing each service item for schools, hospitals, and so on. The use of norms had a number of shortcomings. First, they were tailored to the existing capacity of public facilities, not to the actual needs of the population. Areas that were poorly served with infrastructure thus also had smaller recurrent budgets. Second, since the very existence of facilities justified a recurrent budget (based on norms) to maintain them, there was an incentive to keep underused facilities open. Thus, norms contributed to both inequitable and inefficient allocation of recurrent resources.

Source: Ministry of Finance and Ministry of Health of the Russian Federation; Resolution 105 (March 1991), "On Retail Price Reform and the Social Protection of the Population."

Improving spending assignments.

The concrete and stable assignment of expenditure responsibilities is imperative to a well-functioning system of intergovernmental relations. Without it, the Russian Federation cannot move away from a negotiated form of intergovernmental relations, with all its undesirable consequences. As long as the federal level can change expenditure responsibilities at will, no approach to revenue sharing or assignment will work, and the absence of precise definitions of responsibilities will be a source of tension between the central and oblast-level governments.

Concrete quantification of expenditure assignments is needed, but the basic analytic background work is incomplete. In addition to being clearly assigned, each function must in principle be priced so the government responsible is able to acquire and manage the funds necessary to provide the service. Ideally, a systematic, data-intensive study is needed to estimate the spending responsibilities of subnational governments and, in turn, their financing requirements. This task requires a function-by-function analysis of expenditure responsibilities based on broad indicators (for example, cost of education can be estimated from the number of students) and an estimate of the financial requirements, including new and recurrent expenditures. An assessment of the yield of alternative revenue assignments against these expenditure needs based on a simulation analysis of alternative assignment possibilities would follow. Such analysis is essential to determining the impact of any transfer

of responsibilities, assets, or enterprises, or of any central mandates for wage increases and price ceilings.

Safety net spending. Reassignment of responsibility for social transfers and safety net expenditures should also be considered. Financing social protection for those most hurt by liberalization and economic restructuring will be a challenge, and it is not clear that subnational governments alone should be saddled with this responsibility. Many analysts believe that the decision to transfer responsibilities for social assistance and the safety net to subnational governments was made too quickly. Oblast and rayon governments are not currently well positioned to finance redistributive programs, although they may be able to administer direct transfers if funding is provided.

The adequacy of Russia's transfer system and safety net is (and will remain) a national priority during the difficult transition ahead and should not be the responsibility of subnational governments alone (Barr 1993; Wallich 1992a, 1994). The central government is in a better position to finance social assistance or welfare subsidies (most likely in the form of cash) for the needy, although administration of the cash-based transfer programs is best done closer to home. Rayon administrations could use some form of targeting—income or means testing—to identify needy recipients. The rayons might continue to administer this social safety net, with reimbursements based on payments made by the federal level through cost reimbursement grants.

Capital investment spending. Capital expenditure assignment also requires reexamination. In principle, the responsibility of subnational governments should be limited to capital investments of a local nature that correspond to their assigned responsibilities for current expenditures, such as for schools, local roads, and other subnational infrastructure. Decentralizing investment responsibilities for capital goods with a local benefit zone to subnational governments can increase efficiency, provided that the subnational governments have adequate funds. Oblasts have a better understanding of the type and level of investment required. Unifying the decisionmaking process for investment and recurrent spending and maintenance also will address the perverse incentives (such as the incentive to neglect maintenance) associated with assigning capital spending to one level and recurrent budgets to another.

Several constraints on the flexibility and discretion of subnational government budget activities impede realizing the gains in efficiency from decentralization. These constraints include the scrutiny, if not the required approval, of the Ministry of Finance, the effective limits placed on subnational spending by the negotiated tax shares, and, for deficit oblasts, the negotiation of agreed expenditure levels and subventions. Also, unfunded mandates from higher to lower levels of government reduce subnational autonomy and can destroy the balance of intergovernmental relations. Unfunded expenditure mandates in the Russian Federation include shifts in social and investment responsibilities and across-the-board wage increases and pension adjustments that are required regardless of the budgetary position of the oblast government. Many would uphold the principle that there should be no mandates without funding (McDowell 1994).

Revenue system and structure

The revenue- and tax-sharing system in place when Russia gained independence in 1991 was an extension of the system that governed intergovernmental relations in the former Soviet Union. Beginning in November 1991 the Russian Federation took over the Union's revenue and expenditure responsibilities and began to pursue sovereign tax policies. Broadly, the Russian system of revenue

sharing was characterized by two distinct features. First, unlike in most intergovernmental fiscal systems, in which the center collects and shares national revenue with lower levels of government, revenue in the Russian system is shared upward from rayons to oblasts and then to the federal budget. Upward sharing contributed to the dissolution of the U.S.S.R., as republics stopped making transfers to the state, and a similar vulnerability exists today for the Russian Federation. Second, the system is not a system, but a collection of ad hoc, negotiated, nontransparent agreements whose effects are not well understood. The bargaining inherent in this system makes subnational governments highly dependent on the center and creates considerable uncertainty about their fiscal autonomy and responsibilities.

Subnational revenues and revenue shares

Most subnational government revenues are derived from shared taxes whose rates and bases are set by the federal government. All taxes are shared on a derivation basis, that is, with the jurisdiction in which they were collected. Sharing rates are set by the government and the Duma. Russia's national tax system includes the familiar set of market economy taxes: personal income tax, corporate income tax, value added tax, excise taxes, and taxes on natural resources and trade (box 9.2). Actual data for 1992 and budget estimates for 1993 show that subnational governments obtained more than two-thirds of their revenues from four taxes: personal income tax, company income tax, value added tax, and excises (table 9.2). In 1992 these taxes accounted for about three-quarters of subnational revenue. Subventions and transfers to autonomous regions in 1992 amounted to less than 13 percent of subnational government revenues, a figure lower than many would expect. The remaining 14 percent of subnational revenues came from a number of smaller subnational taxes and fees. Budget estimates for 1993 suggest a similar pattern, though there has been some increase in the reliance on subventions. On average, subnational governments retained about 45 percent of total national tax collections in 1992 (table 9.3). When subventions and transfers are factored in, the subnational share of total national revenues is closer to 60 percent.

Box 9.2 Major taxes in the Russian Federation, 1993

Personal income tax (PIT). The PIT is a federal tax withheld by employers that applies to most wage earners. A standard deduction, exemptions for children and other dependents, and several other deductions are allowed. While in principle the PIT incorporates a schedule of rates ranging from 12 percent to 60 percent, it is essentially a flat rate tax: the bracket of 12 percent is wide, applying to annual income of up to 250,000 rubles—more than ten times the prevailing minimum wage. The highest rate— 60 percent—applies to earned income that, when the tax was introduced, exceeded the minimum wage by more than 100 times. The self-employed are required to file and pay the PIT quarterly. For the purposes of tax assignment under the Basic Principles law, the PIT is assigned to the locality of the taxpayer's employment, not his residence. In the law, PIT is assigned 100 percent to the oblast level. Oblasts may pass it on to rayons.

Company income tax (CIT). This tax was modeled after the corporate tax of industrial countries and is levied at a rate of 35 percent. The law permits oblast-level governments to offer exemptions and preferences

on the part of the CIT that accrues to the oblast level. While 100 percent of CIT accrues to the oblast level by law, it is being divided in 1994 between federal and oblast levels, which receive 13 of 35 percentage points and 22 of 35 percentage points, respectively. The CIT has several shortcomings: no adjustments are made to insulate taxable profits from inflation, and depreciation rules do not yet conform to any notion of economic depreciation. There is a move to reform the CIT by replacing it with a tax on the enterprise's income—defined as profits plus wages. This change would seek to discourage excessive wage increases in state enterprises. Special laws deal with the taxation of the net income of the banking and insurance sectors.

Value added tax (VAT). The federal VAT was introduced on January 1, 1992 to replace both the classic turnover tax (which was levied on the difference between administratively set retail and wholesale prices) and the 5 percent sales tax that had gone into effect in February 1991. Under the VAT, exports outside the Commonwealth of Independent States are zero rated. Imports from the rest of the world were exempt until 1993. The standard rate is 28 percent, but in February 1992 a 15 percent rate was introduced for retail sales of some foodstuffs. Some oblasts have also made unilateral adjustments (downward) to VAT rates applicable in their territory. VAT is shared between the center and oblasts; in 1994 oblasts receive 25 percent, and the federal level 75 percent.

Excise taxes. Federal taxes are levied on alcoholic beverages, tobacco products, automobiles, and some luxury goods at rates varying from 14 percent to 90 percent. These rates are expressed as a proportion of the excise-inclusive price. For spirits, for example, the statutory rate of 90 percent means that for every 100 rubles paid by purchasers, 90 rubles are tax and 10 rubles are kept by the producer. The 90 percent rate thus corresponds to an implicit rate of 900 percent on the excise-exclusive price. Excises are not levied on exports outside the Commonwealth of Independent States area, nor on imports. Excises are shared between the federal and subnational governments, with rates identical for all oblasts, but sharing rates depend on the type of commodity. All excise taxes collected from beer, leather, fur, and certain other luxury items are retained locally and go to the oblast government. The excise on vodka is evenly shared by the federal and oblast levels. Motor vehicle excises are a federal revenue. About 60 percent of all excise tax collections are allocated to subnational governments.

Other taxes. Other legislation imposes taxes on inheritance and gifts, individual property (automobiles and real estate), transfers of bonds, stocks, and other securities, and various small taxes and stamp duties. Most of these are federal taxes.

Source: Ministry of Finance of the Russian Federation.

Table 9.2 Distribution of subnational government revenues, Russian Federation, 1992–93
(billions of rubles)

Revenue Source	1992 ^a		1993 ^b	
	Amount	Percentage of total	Amount	Percentage of total
Personal income tax	431.3	16.1	1,837	11.5
Company income tax	920.9	34.5	5,522	34.9
Value added tax	498.1	18.6	2,614	16.4
Excise taxes	110.8	4.2	697	4.4
Land and property tax	108.6	4.1	Include in "Other taxes"	n.a.
Natural resources royalties and payment	104.7	3.9	Include in "Other taxes"	n.a.
Stamp duties and other nontax revenue	—	—	Include in "Other taxes"	n.a.
Revenues from privatization	43.4	1.6	Include in Other taxes"	n.a.
Other taxes	125.6	4.7	2,385	15.0
Subventions	142.5	5.3	2,860	18.0
Transfers to autonomous regions	186.1	7.0	Included in "Subventions"	n.a.
Total	2,672.3	100.0	15,917	100.0

n.a Not applicable.

—Not available

How revenues are shared

Russia's first attempt at formalizing and legislating revenue sharing was made in 1991 with the Law on the Basic Principles of Taxation, never fully implemented. Since then revenue shares have been determined in each quarterly Budget Act. In the 1994 formally legislated tax shares (summarized in table 9.4), the personal income tax was fully retained by local governments (rayons), with revenues flowing to the rayon of employment. For 1995, 15.5 percent of the personal income tax revenues will accrue to the federal budget. Revenue yield is strongly sensitive to the current high rates of inflation and resulting changes in tax brackets, personal exemption levels, and wage levels. The tax is administered by the enterprises, who collect it on a withholding basis and keep all employee records.

Table 9.3 Revenue sharing by type of tax, Russian Federation, 1992–93
(percentage of total collections)

<i>Revenue Source</i>	<i>1992 subnational</i>	<i>1993 budgeted</i>
	<i>retention</i>	<i>subnational retention</i>
Personal income tax	100.0	100.0
Company income tax	58.8	66.7
Value added tax	24.9	30.4
Excise taxes	52.3	61.5
Foreign trade taxes	1.7	—
All other taxes	65.2	—
Total	44.7	43.4a

Table 9.4 Federal revenue-sharing rules, Russian Federation, 1994

<i>Revenue source</i>	<i>Amount allocated to subnational government</i>	<i>Method of distribution among oblasts</i>	<i>Comment</i>
Personal income tax	100 percent	Derivation, by place of employment	Fully allocated to the rayon level
Company income tax	Tax rate is up to 38 percent; 13 percentage points belong to the central government	Derivation, by place of employment	Oblast may reduce rate
Value added tax	25 percent ^a	Derivation	75 percent accrues to the federal government, of which 22 percent is redistributed to subnational governments for subventions
Excise on vodka	50 percent	Derivation	
Other excises	100 percent	Derivation	Excise on motor vehicles are fully allocated to the federal level
Subventions and transfers to autonomous regions	Ad hoc determination	Ad hoc determination	Distribution largely based on approved deficits and special projects

a. The rate varied, with an ad hoc determination of the percentage for each oblast until 1994.

Source: Ministry of Finance of the Russian Federation.

An enterprise income tax of 35 percent is levied on company profits. Oblast-level governments may retain an amount equivalent to 22 percentage points and must turn the remaining 13 percentage points (about 37 percent of revenues) over to the federal government. Oblasts may increase the tax rate to 38

percent or reduce it to 33 percent, but the federal claim must remain at 13 percentage points. Revenues from the enterprise income tax are sensitive to federal decisions about input and output prices, capital consumption allowances, and redefinitions of the tax base. The tax-sharing rates were changed frequently throughout 1992, 1993, and 1994, often quarterly.

The value added tax (VAT) is shared with subnational governments on a derivation basis, but until early 1994 the share of collections that could be retained varied by oblast, with some retaining as much as 100 percent and others as little as 10 percent (table 9.5). On average, oblasts retained about 20 to 30 percent of VAT collections in 1992. These retention rates were established in an ad hoc way and were changed frequently in the past years. In 1993 most oblasts retained 40 to 50 percent of VAT collections, although the subnational sector retained 30 percent as a whole (see table 9.3). In 1994 the VAT sharing rate was a uniform 25 percent for all oblasts, with 75 percent going to the federal budget.

The trend in the tax retentions appears to favor subnational governments when subventions (discussed below) are included, though it is not clear whether the increase has been sufficient to offset increased expenditure responsibilities (Martinez-Vazquez 1993b).

Table 9.5 Retention rates for the value added tax, Russian Federation, 1992–94
(number of oblasts)

Retention rate (percent)	1994	1993	1992, Q2	1992, Q1
0 to 10	0	0	0	14
11 to 20	0	2	89 ^a	11
21 to 30	89	2	0	19
31 to 40	0	3	0	17
41 to 50	0	60	0	5
51 to 60	0	0	0	4
61 to 70	0	0	05	
71 to 80	0	0	0	0
81 to 90	0	0	0	1
91 to 100	0	0	0	13
Total number of oblasts	89	89	89	89
Median retention rate	25	50	20	30

a. All eighty-nine oblasts were given identical value added tax sharing rates during this quarter: 20 percent. Variable sharing rates resumed thereafter.

Source: Ministry of Finance of the Russian Federation.

Subventions and transfers

Under the system that prevailed until 1992–93, transfers played a minimal role, since the major emphasis was on shared taxes allocated on a derivation basis. At the end of the quarter the Ministry of Finance would provide ex post subventions to oblasts on the basis of its assessment of their needs. Thus, neither the amount nor the distribution of these subventions was formally established beforehand. And there was no entitlement to any transfer.

In a notable move away from the old system, the budget plan for 1994 called for a more objective method of revenue distribution. In principle the bargaining scheme was replaced by a formula based

method of determining subventions for oblasts needing “some support” and oblasts needing “considerable support.” Subventions for oblasts needing some support are being granted to those oblasts with per capita revenues below the oblast average revenue level in an amount sufficient to bring them up to the average. To finance both kinds of subventions in 1994, a fund equivalent to about 16 percent of the VAT (22 percent of the federal VAT share, which in turn is 75 percent of total national VAT collections) was set aside. About three quarters of the fund went to oblasts “needing considerable support” with below average revenues in 1994. The remaining revenue went to oblasts that could not meet their agreed expenditure needs even after receiving their subventions. The definition of these expenditure needs is negotiated with the Ministry of Finance in the course of budget discussions. So these additional subventions remain negotiable, both in volume and allocation. In practice, some oblasts with above average “agreed” expenditures and above average tax ratios are also benefiting. Thus, in 1994 subventions went to fifty eight oblasts needing “some support” and to twenty three oblasts needing “considerable support.” The 22 percent share of the federal VAT share has proved insufficient; in early 1994 the Ministry of Finance estimated that at least 30 to 35 percent of the federal VAT would be needed; in the 1995 budget 27 percent of federal VAT revenues are slated for the fund (about 20 percent of total VAT collections).

This transfer system has questionable incentive effects on oblasts. First, tax effort is not rewarded since actual revenue collections rather than revenue capacity is used in the formula. (This assumes subnational governments can influence the collections vigor of national taxes such as the VAT, through their influence on local State Tax Service officers.) Second, oblasts, whether falling just below average revenues or well below the average, all benefit by being brought to the same level—the average. Third, providing subventions to oblasts that cannot meet agreed expenditure needs may benefit high spending oblasts that have above average revenues. Designing well functioning transfer systems is discussed in depth later in the chapter.

Special fiscal regimes

Since independence several oblasts have adopted special fiscal relations with the federal government that are without legal sanction and that violate the revenue sharing conventions (Litvack 1994; see also chapter 10). In Bashkiria the oblast government has negotiated a single channel agreement with the federal government under which it retains all revenue from all taxes collected in its territory and transfers a fixed nominal amount each month to the federal budget. This agreement has not been sanctioned by the Parliament. Urmut has a single-channel agreement similar to Bashkiria's. Since March 1992 Tatarstan, an oil-rich oblast with potentially huge natural resource revenue, has withheld revenue transfers from the Ministry of Finance. About twenty oblasts, at one time or another, have unilaterally decided to determine what proportion of taxes they will share with the center. The refusal to remit what is due to the federal budget is made possible by Russia's “bottom up” system of tax administration in which revenues are collected (and withheld) below, and passed on to the oblast and, finally, the federal budgets. Oblast tax departments have the ability, if not the authority, to withhold revenues they collect, and thus to bargain for a better deal.

The proliferation of such regimes poses a danger to the Russian Federation, just as the failure of the Union republics to contribute to the Union budget helped foster the dissolution of the U.S.S.R. in 1991. The Supreme Soviet (Duma) has threatened to apply sanctions to oblasts that pursue either single-channel agreements or unilaterally determined sharing rates. The sanctions would stop all central

budgetary expenditure and investments on the territory, withhold the oblasts' export and import licenses, deny central bank credit, halt material supply from the central supply system, and withhold cash or currency. These measures, whose threat is more apparent than real, reflect the limited tools available to the federal government to influence subnational behavior (see chapter 10).

Tax administration

Until November 1991 the State Tax Service, a department within the Ministry of Finance, was responsible for tax administration. Revenue collection was undertaken by highly decentralized oblast and rayon tax offices supervised by their own oblast finance departments and by finance officers of the federal ministry. No single authority or revenue commissioner was in charge of all tax administration activities. This dual leadership—with tax officers reporting to both the Ministry of Finance and the subnational government—caused a conflict of interest, and oblast interests often received priority. Why? Because locally owned enterprises generate employment and are a measure of the success of local officials, so local authorities benefit by keeping taxes low and increasing the proportion of earnings retained in enterprises and thus in the local area—a practice local tax officials may be encouraged to permit. Such enterprise retained earnings could be used for social service expenditures or tapped for donations to local projects.

Since 1991 the State Tax Service has been an autonomous agency with ministerial ranking. It is now in charge of administering all taxes in the Russian Federation through its three-tiered organizational structure: central, oblast, and rayon. Although the dual leadership structure has been formally replaced, conflicts of interest remain, in part for historical reasons. Local State Tax Service officials remain closely tied to local finance departments, and there is no rotation of personnel. Most local State Tax Service officials were part of the local finance office and many are lifelong residents of the community. In some instances, the local oblast administration is responsible for providing local State Tax Service staff with housing, utilities, and other fringe benefits such as food coupons and other noncash allowances, which in the Russian system can provide over half of the total compensation package. Local governments may also contribute wage bonuses to tax officials although the wage itself is paid out by the state. Thus, while strictly speaking local tax administrations are the deconcentrated arm of the central administration, in practice, their loyalties and their ties to the local authorities are strong. Dual subordination, though formally ended, has by no means disappeared, and local tax officers and offices still may respond strongly to local policy concerns. The internal organization of the nationwide State Tax Service must be strengthened to improve resource mobilization and institute a workable intergovernmental system. Without it, the federal budget remains vulnerable. Ultimately, Russia should aim to have a strong, centralized system of tax collection—which, up to now, it has had more in form than in substance. Separate subnational administrations for local taxes may be appropriate in the future.

Macroeconomic dimensions of subnational finance

Tax policy, tax administration, and revenue sharing are integral components of the intergovernmental fiscal structure in Russia, and subnational government finance has important consequences for macroeconomic policy. In fact, the current transitional approach to intergovernmental fiscal relations may threaten the success of Russia's macroeconomic stabilization program. The current system does not explicitly provide funds to meet the expenditure responsibilities that have been shifted down to subnational governments. Thus, subnational governments look for backdoor approaches to create the revenue sufficiency the system does not provide and to balance their budgets. This combination of

bottom up tax administration, increased expenditure responsibility, extrabudgetary funds, and subnational government borrowing through enterprises allows them to do this, but can complicate macroeconomic management and is potentially destabilizing (EBRD 1994; Sachs 1994a, 1994b). Subnational deficits cannot on their own create macroeconomic problems since subnational governments do not print money. But, because subnational governments have little authority to expand their own revenues, deficits are increasingly being financed by credit expansion, with subnational deficits being monetized through central bank loans to local enterprises, banks, and governments. Not only does this put pressure on national budget policy but it also disguises the root of the problem. Advocates of a strong stabilization policy argue that the federal government must regain control over all of these aspects of revenue mobilization and expenditure determination. It must also design a properly functioning intergovernmental system. And monetary and structural reforms will be needed.

Russia's stabilization challenge.

Stabilization remains a major challenge. Macroeconomic performance in the Russian Federation has been sluggish over the past few years, with inflation—and sometimes hyperinflation—plaguing the nation, along with falling output and employment. In 1992 inflation was 1,354 percent. It fell to 895 percent in 1993 and subsided slightly in early 1994.⁴ The 38 percent drop in GDP since 1991 has reduced government revenues at a time when the government's fiscal responsibilities have expanded, squeezing an already tight budget. In 1992 budget revenues were 31.5 percent of GDP, spending 37.8 percent, and the fiscal deficit 18.2 percent. In 1993 revenues and expenditures fell slightly as a percentage of GDP, to 29.2 percent and 34.8 percent, respectively, and the fiscal deficit remained high at 7.9 percent of GDP.⁵ The actual budget deficit was estimated at 10 percent of GDP in 1994, and in 1995 the forecasted budget deficit is 7.8 percent of GDP. This fiscally strained situation both limits and influences the government's options for the design of an intergovernmental fiscal system. The center argues, for example, that it cannot cede control over any of the major tax bases to the subnational level.

The government's current stabilization program implies fiscal austerity at both the central and subnational levels and calls for implementation of a federally directed program of tax rate adjustments and expenditure cuts. On the revenue side, the value added tax, corporate income tax, and personal income tax were all changed significantly in 1992 and 1993. The 1994 fiscal program called for revisions in the taxation of petroleum products and foreign trade. The 1995 budget proposes lowering the profit tax and the value added tax while increasing the personal income tax. On the expenditure side, continued cuts are planned in investment, producer and consumer subsidies, and operational and maintenance outlays. Priority will be given to certain types of investment and social protection. Social protection expenditures, financed from subnational budgets, are projected to increase significantly during this transition period.

The federal government has the policy tools in principle to design such a program, including the authority to set expenditure and tax levels and to adjust revenue sharing to ensure budgetary balance at the federal level. But it may not have the power to implement such a program. For example, in the past two years some oblast governments have been unwilling to remit the full federal revenue entitlement; others may have dampened tax collection rates by encouraging the local tax administration officials of the State Tax Service to overlook revenue obligations of local enterprises; still others have made the case for significant increases in their subventions and tax sharing retention rates. Thus, it is not clear to what

extent the federal government has been able to control the rate of revenue mobilization and the division of shared revenues.

Revenue-expenditure mismatches

Until recently most cuts in expenditures other than consumer subsidies have affected primarily the federal budget. The central government's strategy has been to push the deficit down by shifting unfunded expenditure responsibilities to subnational governments, hoping that they will cut costs. The shift of financing responsibility for major social expenditures and capital investment to the subnational level suggests that much of the additional expenditure will have to be financed from local sources, worsening the vertical imbalance in the intergovernmental fiscal system and increasing horizontal imbalances between oblasts with a robust revenue base and those without. Other factors heighten the mismatch between revenues and expenditures at the subnational level: federal price controls on local services and rents, the cost of the social safety net and capital investments, pressures from wage and other mandates, and the assumption of the myriad public expenditure responsibilities (for education, health, and housing) now handled by state enterprises.

The success of the macroeconomic reform program depends on how subnational governments respond to this pressure and to what extent the federal government holds to its course. If the center transfers additional resources to the oblasts—for example, by allowing greater subnational revenue retentions or granting larger subventions—so that oblasts can fulfill their new expenditure responsibilities, the enlarged fiscal deficit and its possible monetization could destabilize the economy. If the federal government resists transferring adequate financial resources, subnational governments could address the fiscal squeeze with other solutions that threaten economic reform and stability.

Subnational governments already have developed several coping mechanisms to deal with the restrictive federal policies:

- Spending above allowable limits and accumulating arrears that may come to be monetized.
- Negotiating increased subventions or higher value added tax retention rates with the center, depriving the center of revenues.
- Failing to turn over the federal share of tax revenues, with similar effects.
- Borrowing from locally owned banks (or borrowing through local enterprises, to evade the current ban on local government borrowing), thus possibly monetizing the subnational deficit if these additional credit demands are validated by credit expansion at the central level.⁶
- Relying more on locally owned enterprises to finance infrastructure investments, with the additional credit demand this can imply.
- Protecting the local tax base by supporting local enterprises with trade barriers and purchasing restrictions.
- Pressuring locally owned banks to increase credit to area enterprises, which is in turn monetized.

These mechanisms, when deployed in response to misaligned expenditure and revenue responsibilities, could threaten macroeconomic stability and privatization (Sachs 1994a, 1994b; EBRD 1994). Perversely, economic stabilization efforts pursued through deficit reductions at the federal level are inducing

responses at the subnational level that could further destabilize the economy. Moreover, some of these local reactions (such as extrabudgetary funds, arrears, and quasi-fiscal operations of banks) reduce budgetary transparency and make it more difficult for the federal government to monitor subnational fiscal activity. There is a need for new intergovernmental fiscal arrangements that fairly address the needs of each government level, that establish correspondence between expenditures and revenues, and that ensure that the pressures on budgets at the subnational level do not undermine the national stabilization effort. Without adequate own-revenues shared taxes, and transfers, and with increased expenditure responsibilities, subnational governments will continue to resort to solutions that could threaten stabilization and overall economic reform.

Borrowing and extrabudgetary funds

Budget laws have given subnational governments an unlimited right to borrow funds and to establish and own banks, but the authority to borrow was suspended by the central bank from 1992 until recently.⁷ In 1994 a number of oblasts issued local bonds. While the use of credit by subnational governments is currently limited by the absence of suitable financial markets, it is an important aspect of intergovernmental finances and could have major macroeconomic repercussions.

Subnational borrowing is a critical issue in intergovernmental finance. In some industrialized countries, including the United States, state and local governments have substantial discretion to use debt financing. In other countries subnational governments cannot borrow at all. The federal government in Russia may want to limit or prohibit subnational government borrowing for macroeconomic reasons, such as inflation control, spending reduction, and the fear that some oblast-level governments might acquire heavy debts because of highly volatile revenue and expenditure developments. In the long run, oblasts or large cities might be granted some discretion in using debt, such as in bond financing of long-term capital investments (see chapter 1).

Another source of subnational government financing is extrabudgetary revenues, including past unspent funds, voluntary contributions, funds from commodity auctions, tax penalties and other fines, certain nontax revenues, and loans. At the subnational level, the use of extrabudgetary funds has grown rapidly as a result of the increased spending responsibilities that have been passed on to subnational governments. Extrabudgetary funds are attractive to oblasts because they can spend them at their discretion, whereas most budgetary funds are subject to some degree of higher-level approval. Another advantage of these revenues is that they need not be shared with higher levels, giving oblast governments an inducement to shift as much of their revenues as possible from the budgetary to the extrabudgetary category.

The proliferation of extrabudgetary funds at the subnational and national levels presents serious problems for effective budgetary management by the federal government. There are now more than twenty extrabudgetary funds at the national level and an unknown number at the subnational level. The principal national funds are earmarked for social purposes (Pension Fund, Social Insurance Fund, and the like) and for investment (Road Fund, Fuel Fund, Research and Development Fund). The use of extrabudgetary funds reduces the transparency of consolidated budgetary operations, making it difficult to assess the impact of aggregate fiscal policy as well as its sectoral impacts. Recently, the revenues of federal extrabudgetary funds were estimated at 107 percent of federal budgetary revenues, and 58 percent of consolidated budget revenues (Dubinin 1994), bringing total public revenues up to 48 percent of GDP (from 31 percent). Extrabudgetary funds function as parallel accounting systems, outside the

structures of conventional budgetary procedures. The use of these funds is an inefficient budgetary practice from the federal government's point of view because they provide loopholes for public sector operations not approved through proper budgetary channels and thus weaken fiscal policy as a macroeconomic instrument. Moreover, by clouding subnational budgetary aggregates on both spending and revenue sides, extrabudgetary funds can complicate the task of transfer design and equalization policies.

On the other hand, the availability of extrabudgetary funds may improve the efficiency of subnational government spending by allowing greater spending discretion than is allowed them for their budgetary funds, which remain subject to central scrutiny and norms. Indeed, the greater spending discretion that extrabudgetary funds provide is the main attraction for the subnational governments as well as for the central government ministries and agencies that use off-budget accounts to cloud spending priorities and ceilings. However, earmarking via extrabudgetary funds creates its own inefficiencies. Earmarking is in general only justified if the taxpayers are also the beneficiaries, if it ensures the quality of the service or revenue collection, and if it will lead to the appropriate quantity of the service being provided (McCleary 1989).

Because of the macroeconomic disadvantages of loose budgetary control and the informational complications implicit in this practice, there is a reasonable case for discontinuing the extrabudgetary accounts. However, the creation of these funds is within the law, and the practice is now well entrenched.⁸ A realistic transitional approach for the central fiscal authorities would be to require subnational governments to disclose information about the sources and uses of extrabudgetary funds while this financial practice is phased out.

Decentralization and privatization

The shifting of ownership and the privatization of enterprises have had a significant effect on subnational government budgets. Because the focus of policymakers and advisers has been directed to the efficiency aspects of the private sector takeover of production, intergovernmental fiscal dimensions of privatization are often overlooked. In Russia the privatization process may result in a revenue inflow for local governments from the sale of assets because the government that owns the enterprise recovers the proceeds from the sale of its assets. Dividends, rents, and lease income also accrue to the owning government at the time of divestment. Revenues from privatization accounted for about

1.6 percent of total subnational government receipts in 1992 and account for more now (Le Houerou 1994). There are no guidelines on using revenue from the privatization of public enterprises, but the most common practice is to add the proceeds to general budgetary revenues. However, the privatization process will also result in the transfer of significant expenditure responsibilities from enterprises to local governments. When enterprises are privatized, there is often a need to transfer social assets to local governments, resulting in an increased claim on local government revenues. Thus, the net fiscal impact on local budgets of the privatization and decentralization of enterprise ownerships is far from clear (Bahl and others 1993).

Asset transfers and entrepreneurial activities of subnational governments

Oblast and rayon governments are becoming owners of business enterprises, housing, and vacant urban land as such assets are transferred from the central government in the course of decentralization. These

asset transfers are a mixed blessing. They are consistent with rhetoric about more subnational autonomy, and they increase subnational government gross wealth. But they may bring subnational governments increased maintenance and subsidy burdens. Many of the enterprises transferred to local governments require an operating subsidy, either because they provide local public goods at subsidized prices or because they are unprofitable.

There are only a few options: increasing user charges to hasten cost recovery, accelerating the privatization of assets (which may also imply absorbing their social assets into the local budget), and bargaining with the center for additional revenues. There do not appear to be hard estimates of the fiscal implications of asset transfers, nor has the federal government required that these estimates be made.

With the endorsement of new laws on local self-government, some subnational governments view their role as not only that of service provider, but also entrepreneur and producer. Localities appear optimistic about their ability to enhance revenue by establishing joint ventures with a domestic or foreign partner, or with another state enterprise, using locally owned assets as the equity share. Typically, these ventures involve purely private, "market" oriented activities such as industrial products or hotel services. There are good reasons for local governments in Russia to become involved in new joint ventures. Not only is there a prospect of increased revenues, but profits and dividends from such ventures can be treated as extrabudgetary revenues. There are also important drawbacks to the use of commercial ventures for revenue-raising purposes. First is the inconsistency with the government's goals for privatization. Second is the failure to distinguish between tax revenues and profits from the ownership of industry, which encourages an unhealthy form of intergovernmental mercantilistic rivalry. Local governments may be tempted to protect their enterprises from competition, for example, by prohibiting "imports" from adjacent oblasts. This practice perpetuates bureaucratic management, one of the main targets of the enterprise reform. Finally, the development of government business may have unfavorable fiscal consequences. Expectations of profit sharing in joint ventures can quickly turn into budgetary obligations to cover losses. Public officials tend to be poor business managers, confusing such objectives as income maintenance or retaining jobs with the objective of maximizing profits.

Enterprise provision of social services

Economic restructuring is predicated on government withdrawal from activities that can be more efficiently undertaken by private firms. But privatization also means that government must assume responsibility for some of the government services that were previously delivered by state enterprises (Bahl and others 1993).⁹ Enterprises construct and support hospitals, housing, kindergartens, and preschools and make donations to finance public transport systems and to supplement the extrabudgetary funds of subnational governments. Public enterprises also make capital investments in the social sectors that benefit the local population, including building schools and hospital facilities and then transferring their operation to oblast or rayon governments.

Subnational governments have long looked to state enterprises to finance many essential public services. The enterprise contribution was estimated at 40 percent of subnational budgetary outlays in early 1992 (Martinez-Vazquez 1994a). And in some one-company towns, all social infrastructure outlays may be undertaken by the enterprise with no budgetary funding at all. In Vorkuta, a one-company coal-mining town in the far north, nearly all social services, cultural facilities, parks, roads, infrastructure, education, housing, and health services are provided by the local coal enterprise. The rayon budget finances only

routine public administration overheads. Currently, enterprises find it difficult to transfer their social spending responsibilities to subnational governments that lack the resources to assume these new functions. Indeed, the reverse is true as revenues diminish and their expenditure mandates increase, subnational governments increasingly try to rely on enterprises to provide basic services. Enterprises often have better access to credit than subnational governments do. This adds to pressures for credit creation. The federal government does not appear to have quantified the dimensions of this problem, nor has it planned a solution although experiments are ongoing to shed social assets.

There is another intergovernmental dimension to this issue. The spinoff of enterprises' social expenditures can reduce the need for government subsidies to enterprises or increase an enterprise's disposable after-tax profits. But under the current revenue-sharing system it is not certain that the revenue benefits will accrue to the same level of government that must pick up the added expenditure responsibility. For example, the local government may have to absorb all the added spending if a clinic is off loaded; however, the incremental enterprise profit taxes go in large measure to the center. Concrete, quantitative analysis of the budgetary implications of this divestiture must be undertaken to determine whether the realignment of these expenditures corresponds with the local government's ability to finance them.

The tax-sharing and transfer system

The system of subnational government financing in the Russian Federation is in transition. In the long run, the intergovernmental fiscal system will almost certainly include some form of tax assignment, probably supported by an equalizing federal grant program. Russia is too heterogeneous, too heavily populated, and too geographically vast to succeed as a highly centralized fiscal federation. In the short time since the dissolution of the U.S.S.R., changes in fiscal federalism have been driven primarily by macroeconomic concerns. The central government has transferred expenditure responsibilities to lower-level governments to lighten its deficit and has made piecemeal tax-sharing adjustments to placate the now-overburdened subnational governments. Indeed, the greater spending discretion that extrabudgetary funds provide is the main attraction for the subnational governments as well as for the central government ministries and agencies that use off-budget accounts to cloud spending priorities and ceilings.

Given the instability in the Russian economy and political system, it is not surprising that the intergovernmental system is beset by problems. Neither the central nor the subnational governments have confidence in the current system, and they are calling for change. Since no single change can benefit both the federal government and all the oblasts—the system is a zero sum game unless reforms bring about greater spending efficiency—a compromise solution has been slow to emerge. The place to begin the search for such a compromise is with an understanding of the shortcomings of the current system.

Correspondence between revenue assignment and expenditure needs

Russia's current system does not provide correspondence between revenues allocated or assigned to subnational governments and the resources they need to deliver an adequate level of services in their assigned spending functions. Governments worldwide always have a revenue shortage—they are never able to deliver all the services they would like. But the problem with the intergovernmental financing system in Russia goes beyond this chronic revenue problem. The balance between the federal and the

subnational government levels is simply not right. From the subnational governments' perspective, the central government has given them expenditure responsibilities without a corresponding revenue share, revenue base, or independent taxing powers. From the federal perspective, the subnational share of revenues has been increasing and now exceeds 60 percent.

One problem is in the system design. Revenues flowing to the subnational sector and to individual oblasts are determined by the size of their taxable base and by sharing rates for each tax. Neither the income tax bases nor the value added tax sharing rate are necessarily related to the amount of financing required to support a normal level of subnational expenditures. If revenue is overassigned to the subnational governments, there is no way to return revenue to the center under the current laws.¹⁰ If revenue is underassigned, there is no legal requirement to systematically compensate for the difference. More generally, the problem is that revenue allocation decisions seem to have been made early on, independent of decisions about expenditure responsibilities. Instead, expenditure responsibilities should be identified first, so that an appropriate revenue allocation system can be designed.

Tax assignment and tax sharing.

In December 1991 Parliament passed a Law on the Basic Principles of Taxation assigning all of the federal personal and corporate income tax to subnational governments and the value added tax to the federal government (see annex 9.1 at the end of the chapter). This proposal was not well designed in that many important issues were not addressed. Would these revenues be sufficient to meet oblast needs? Would an equalizing grant mechanism compensate for differences in oblast fiscal capacities? What tax rate—setting authority would subnational governments have? How would taxable profits be determined for enterprises operating in more than one oblast? The Basic Principles law—silent on all these issues—was never implemented, but it did raise a debate over tax assignment as compared with tax sharing.

The Basic Principles law introduced a system that relied only on tax assignment, a major departure from the system existing under the Soviet Union and the current system of sharing the value added tax and the corporate and personal income taxes. Strictly speaking, this was not a system of tax assignment, since it gave subnational governments no control over the rate or the base of assigned taxes. Tax assignment that preferably also gives some autonomy over rate or base to the subnational governments is an important part of the long-term solution. The current setting, however, may not be conducive to the radical change that a system of pure tax assignment would create.

Assigning federal taxes (over which oblasts have no control) to subnational governments leaves their budgets vulnerable to changes in central government economic policies: any changes that the center might make in the rate or base of an assigned tax could have critical, unintended effects on subnational revenue. This has already occurred with the recent changes to the federal personal income tax (100 percent of whose revenues accrue to the subnational level) and the value added tax (which accrues in part to the oblast level). Furthermore, such impacts could vary substantially across oblasts in a way that would be hard to predict. Greater instability of subnational revenue could also result, since the base of any one (assigned) tax is more volatile than the base of the entire (shared) tax system. Thus, tax assignment would make subnational government revenue more volatile. In sum, while tax assignment might appear to reduce the dependence of subnational governments on the center, in the sense that all revenues from an assigned tax would accrue to subnational governments, this independence comes at a heavy price since localities would remain vulnerable to centrally determined changes in the tax base and tax rates and would have no fiscal discretion of their own.

Furthermore, assignment is not compatible with an administrative system in which all revenues are collected by a federal tax administration service. As it becomes more centralized, there will be an incentive for the State Tax Service to be more efficient in collecting federal taxes than local taxes and under a tax assignment system, subnational collections might suffer. If all major taxes are shared with the center, as they are now, no such incentive would exist.

How revenues are allocated across oblasts

Is there some rough justice in the current system of revenue sharing, that is, are revenues implicitly distributed among the oblasts in a systematic way? To try to answer this question, a multiple regression analysis was carried out using actual 1992 data for eighty-eight oblasts, with per capita retained revenues (excluding subventions) as the dependent variable (Bahl and others 1993). The independent variables were chosen to reflect interoblast differences in public service needs and fiscal capacity. Of particular interest was whether some implicit formulas might be used to describe the current distribution of shared tax revenues, and whether the actual distribution of revenues across oblasts is related positively to fiscal capacity or expenditure needs. The proxy measures used to indicate fiscal capacity are:

- Average monthly wage.
- Growth rate in the average monthly wage between 1991 and 1992.
- Percentage of the population living in urban areas.
- Population size.

Measures used to describe public services needs are:

- Hospital beds per 10,000 population.
- Percentage of the population over 65 years.
- Infant mortality per 10,000 population.
- Kilometers of roads as a percentage of land area.

Other expenditure needs measures, such as total school-age children, crime rates, and number of handicapped citizens, were not available for many oblasts.

Four results of this analysis stand out (table 9.6). First, about half of the variation in per capita retained revenues can be explained, suggesting that there are other important determinants of per capita revenues accruing to oblasts, or that much of the allocation process is random. Second, oblasts with larger populations retain more revenue on a per capita basis. Third, oblasts with a higher average wage and with higher average wage growth retain significantly more revenue per capita. Finally, there does not appear to be a strong correlation between needs variables and per capita retained revenues: hospital beds, infant mortality rates, and highway density are insignificant determinants of retained revenues. The concentration of elderly population, however, appears to be associated with higher levels of retained revenues.

Together, these results suggest that 1992 revenue distributions were driven in part by the strength of the economic base, that is, wage levels, wage growth, and population size. This finding is consistent with a

similar analysis conducted by the World Bank on data for the first half of 1992 (Wallich 1994; Bahl 1994; Bahl and Wallace 1994).

Table 9.6 Determinants of subnational per capita revenues, Russian Federation, 1992
(ordinary least squares estimates)

<i>Independent variable</i>	<i>Per capita retained revenue^a</i>	<i>Per capita subvention^b</i>	<i>Per capita retained revenue, Cheliabinsk oblast</i>
Constant	-20.581 (1.66)	14.461 (0.61)	-1,927.14 (0.66)
Population (thousands)	1.40 (2.67)	-0.91 (0.76)	5.50 (2.82)
Per capita enterprise profits	..	198.54 (4.60)	..
Average monthly wage	36.45 (3.98)	..	4.69 (0.80)
Percentage of population living in urban areas	-115.10 (1.57)	-28.21 (0.18)	37.91 (3.41)
1991–92 growth rate in monthly wage	1,373.63 (3.58)	-232.16 (0.31)	..
Percentage of elderly in population ^c	350.22 (1.61)	-1,247.10 (3.29)	
Infant mortality per 10,000 population	-10.42 (0.05)	-809.27 (2.03)	-4.51 (0.13)
Hospital beds per 10,000 population	-41.78 (0.80)	224.35 (1.94)	3.10 (0.35)
Highway density ^d	17.72 (1.26)	18.19 (0.60)	..
R2	0.51	0.41	0.60
N	88	88	38 ^e
F-value	12.646	8.476	12.224

.. Variable was not used in the regression.

Note: t-statistics are shown in parentheses below regression coefficients.

- From income, value added, and excise taxes.
- Including transfers to autonomous regions and loans.
- Population over 65 years old.
- Kilometers of highway per square kilometer of land area in the oblast.
- Cheliabinsk's thirty-eight rayons.

Source: Bahl and Wallace 1994; computed from data supplied by the Ministry of Finance of the Russian Federation, June 1993, and from the Finance Department, Cheliabinsk oblast, June 1993.

How equally are revenues distributed?

The assignment or sharing of taxes to the subnational level on a derivation basis necessarily means that higher-income territories with a larger tax base will derive more revenue. Simple correlations reported by Bahl and Wallace (1994) show that both per capita revenues collected and per capita revenues retained are significantly and positively correlated to the money wage (table 9.7). Since this system allocates more revenues to higher-income oblasts, some form of subvention must be provided to protect the budgetary position of territories whose economic base is not strong enough to support an adequate level of public services.

Table 9.7 Selected fiscal measures: variation among the oblasts, Russian Federation, 1992
(rubles)

<i>Statistic</i>	<i>Per capita revenue collected</i>	<i>Per capita revenue retained</i>	<i>Retention rate^a (percent)</i>	<i>Per capita subvention</i>	<i>Subventions as a percentage of total subnational revenue</i>
Mean	15,055	12,078	49.6	7,495	25.19
Coefficient of variation	87.0	71.2	34.2	227	101
Minimum	135	108	38.4	18	0.01
Maximum	88,556	53,634	100.0	126,318	92.14
Simple correlation with money income ^b	0.63	0.59	0.10	0.40	0.10

a. The retention rate is the ratio of taxes retained to taxes collected, expressed as a percentage.

b. A coefficient of 0.21 is significant at the 0.05 level.

Source: Bahl and Wallace 1994; computed from data supplied by the Ministry of Finance of the Russian Federation.

The federal government uses three discretionary actions to equalize the distribution of fiscal resources. First, it approves the final budget expenditures of each oblast. Second, it determines the level of subventions that will flow to each oblast, which is partly determined by the approved spending level. Third, it has varied the sharing rates of regulating revenues such as the value added tax to ensure agreed spending levels can be reached (or cannot be superseded; see table 9.5).¹¹ The value added tax was changed from variable rate sharing in the first quarter to a fixed 20 percent retention in the second quarter, with a return to variable rate sharing by the end of 1992. (A range of these sharing rates was in place until 1994.) The value added tax had the potential for an equalizing effect when it was distributed by the federal government on an ad hoc variable rate basis, but previous studies found no evidence of equalization (Bahl 1994).

How does one measure the success of equalization in the Russian system? Most analysts would agree that the objective is to subsidize oblasts whose fiscal capacity is not sufficient to support adequate levels of expenditures even if the local area makes a reasonable tax effort. In an equalizing system, oblasts with higher levels of expenditure needs and lower levels of fiscal capacity would have a greater tax retention rate.

Table 9.8 Determinants of subnational tax retention rates, Russian Federation, 1992
(ordinary least squares estimates)

<i>Independent variable</i>	<i>Total retention rate, all oblasts (equation 1)</i>	<i>Total retention rate, all oblasts (equation 2)</i>	<i>Total retention rate, Cheliabinsk oblast</i>
Constant	87.00 (5.25)	37.00 (1.88)	11.00 (1.30)
Population (millions)	1.40 (1.42)	0.68 (0.73)	-5.00 (0.99)
Percentage of population living in urban areas	-0.30 (1.70)	-0.14 (0.10)	0.15 (4.86)
Per capita income (thousands)	-0.72 (0.50)	0.51 (0.40)	..
Average monthly wage (thousands)	-3.00 (0.22)
Hospital beds per 10,000 population	0.07 (0.31)
Infant mortality per 10,000 population	0.01 (0.19)
Percentage of elderly in population ^a	-1.00 (2.70)	-0.20 (0.33)	..
Percentage of workers in industry	0.20 (0.65)	-0.10 (0.41)	..
Share of children in second shift in school	0.10 (0.20)	0.40 (1.40)	..
Republic dummy variable	..	15.00 (3.10)	..
R ²	0.15	0.28	0.54
N	87	87	38 ^b
F-value	3.523	5.781	9.902

.. Variable was not used in the regression.

Note: t-statistics are shown in parentheses below regression coefficients.

- a. Population over 65 years old.
- b. Cheliabinsk's thirty-eight rayons.

Source: Bahl and Wallace 1994; computed from data supplied by the Ministry of Finance of the Russian Federation, June 1993, and from the Finance Department, Cheliabinsk oblast, June 1993.

The dependent variable in this analysis is measured as the ratio of taxes retained to taxes collected. The same general indicators of need and fiscal capacity are used as independent variables to explain the distributional features of the present system.

The multiple regression results for tax retention rates are shown in the first two columns of table 9.8. The variation in the level of retention rates across oblasts cannot be fully explained, suggesting that much of clawback provision from oblasts that had a surplus.

However, the Ministry of Finance reportedly refused to reimburse surplus oblasts for wage increases and other mandated expenditures, and asked them to assume more financial responsibility for capital investments.

The unweighted mean level of subvention among the eighty-eight oblasts studied was about 25 percent of total revenues. (The denominator in this calculation is total revenues including subventions.) The subvention level ranged from zero in some oblasts to over 90 percent of total revenues in others. Were the subventions distributed on an equalizing basis? To test for such a relationship, the relationship between the per capita level of subventions for 1992 and the set of independent variables described above was estimated. The regression results show that about 40 percent of the variation among the eighty-eight oblasts could be explained (see table 9.6, column 2). Per capita subventions are significantly higher in oblasts with greater fiscal capacity, as measured by enterprise profits, suggesting a counterequalizing pattern. There is no evidence that per capita subventions are allocated in greater amounts to oblasts where expenditure needs are greater. In fact, results show that per capita subventions are higher in oblasts with greater hospital capacity, a lower concentration of the elderly, and lower infant mortality rates.

Thus, there is no strong evidence that the 1992 revenue-sharing system is equalizing, even if subventions are taken into account. In fact, the distribution patterns of the shared taxes and the subventions are similar, and possibly counterequalizing. Simple correlations between oblasts' money income and their retention rates and between money income and subventions are both slightly positive (see table 9.7).

The proposal implemented by the government for 1994 would change value added tax sharing dramatically. Under the new arrangements, value added tax revenues are divided 75 percent federal and 25 percent subnational. Approximately 16 percent of total value added tax collections (22 percent of the federal government's 75 percent share) are placed into a distributable pool to be shared among the lower-spending oblasts on the formula basis described earlier. The formula begins with normed expenditures agreed on with the Ministry of Finance, subtracts revenues, and makes up the difference for each oblast, to provide it with at least the nationwide average for per capita revenues. However, no adjustments are made for cost differentials or for differing expenditure needs.

Revenue effort

Whether the Russian system has stimulated or inhibited revenue mobilization is an open question. The system is centralized and subnational governments cannot change tax rates or the tax base. However, they can offer incentives, encourage more aggressive tax collection, and shift resources from budgetary to extrabudgetary accounts. Subnational governments do not retain all the revenue they collect. The smaller the retention rate, the larger the disincentive to collect taxes. The possibility of subventions is a further deterrent: Why should subnational governments increase their revenue effort if any shortfall will

be covered by the federal government? Still, subnational governments do retain a significant percentage of some taxes. Moreover, the 1992 experience shows that oblasts can be successful in negotiating larger retentions on an ad hoc basis.

Do oblasts use their fiscal capacity to varying degrees, creating a wide variation in the effective rates of tax collection? The effective tax rate is measured as the ratio of tax collections to the gross value of industrial output (GVIO). This measure does not fairly compare tax effort variations across oblasts, however, because GVIO alone is not a proper measure of taxable capacity. Even for a given per capita GVIO, an oblast with a higher average wage and a more heavily urbanized population would have a greater tax capacity.

Bahl (1994) took such factors into account in a tax effort regression analysis on 1992 data. The analytic model was based on one developed and extended by the International Monetary Fund.¹² The results showed that the ratio of tax collections to annual GVIO was significantly higher in oblasts with a higher average wage and a lower per capita GVIO. About half the variation across the sixty-four oblasts for which data were available could be explained.

Based on these results, it was estimated that the variation in tax effort among oblasts ranged from two times the national average to less than half the national average (see table A9.1 at the end of the chapter). The extent to which subnational governments urge tougher enforcement on local tax authorities and better compliance on their enterprises varies widely. Surprisingly, there is no significant correlation between the estimated tax effort ratio and the tax-sharing rate. Whether an oblast with a higher retention rate acts on this incentive to make a significantly greater tax effort cannot be determined from these data.

Options for a new structure: Formula-based sharing

Three considerations underlie any decision about restructuring the Russian Federation's system of central-oblast financing: macroeconomic stabilization, equalization, and subnational fiscal discretion. Fixed and unchangeable solutions that might be delineated in a Constitution should be avoided for the time being because of the difficult structural and political changes now under way. The fiscal needs of the Russian Federation in ten or even five years will be different from what they are now. The reform options discussed here represent a framework for the future that offers both structure and flexibility.

Reform of fiscal federalism in Russia could take three basic directions. It could remain a highly centralized system with the federal government controlling the level of expenditures and revenue mobilization in each oblast, though this is unlikely given the size and diversity of the country and the political pressures for autonomy. At the other extreme is a decentralized tax assignment system, a more likely choice in the long run, but one that would pose significant transition problems. The other alternative is for the government to use the transition period to adopt a flexible system that includes some tax assignment, tax base sharing, formula grants, and derivation-based tax sharing. Such a system could have four components: a common pool of revenue (to be divided between the federal government and the subnational governments), the partial distribution of the subnational share of this pool across oblasts on a derivation basis, the distribution of the remainder of the subnational share among oblasts on the basis of a formula, and greater use of subnational taxes and surcharges. The federal level would also fully reserve some taxes for its own use, such as those on trade and customs duties.

Establishing and sharing the revenue pool

Revenue from the major federal taxes—personal and corporate income taxes, value added tax, and excises—would notionally be available for sharing between the central and local levels. In 1992 these four revenue sources accounted for 80 percent of total taxes. Subnational spending accounted for about half of national outlays. This suggests that a significant fraction of all of these taxes, or all of some of these taxes, must flow in one way or another to subnational governments to achieve vertical balance, since subnational governments account for 50 to 60 percent of total spending. (The exact amounts in the future would depend on the estimated costs of concretely and explicitly assigned central and local expenditure responsibilities.) Direct assignment of some of these taxes to the subnational level might not be feasible, since the center would not give up a major revenue base, in toto, nor cede to the oblasts this degree of control over the allocative dimensions of tax policy. This suggests the need for some form of tax sharing, transfers, and the assignment of the nonmajor tax bases.

The subnational revenue share, once its aggregate volume is determined, would be distributed across oblasts partly on a derivation basis as at present—meaning that taxes would accrue to the budgets of oblasts where they were collected—and partly on a formula grant basis. Decisions about the relative proportions of the subnational revenue share amounts to be distributed on a derivation basis versus the amount to be distributed by formula would depend on political and economic considerations. From an economic perspective, the more revenues that are shared by derivation, the more the system will channel resources into regions with larger taxable bases, giving more revenue to higher-income territories whose growth potential is highest. This approach would reward oblasts that attract industry and deploy budgetary resources to spending and investments that enhance productivity and private sector development. Moreover, derivation-based sharing has the advantage that it builds on Russia's existing system and is easy to monitor and administer. The larger the proportion of the overall subnational share that is allocated on a formula basis, the more equalizing the overall system may be, depending on the exact design of the formula. The tradeoff between encouraging growth and ensuring equalization is difficult. In one view, the intergovernmental system should place significant weight on the initiatives and fiscal energies of better-off areas, in the interests of higher economic growth. This would argue for channeling a relatively large fraction of revenue to sub-national governments on a derivation basis. Another view is that fiscal disparities in Russia, if not addressed, could give rise to unacceptably large disparities in service provision and well-being. Under this view, a significant fraction of the overall subnational revenue pool would be distributed on an equalizing, formula basis. The choice is not an easy one.

To enhance the transparency and revenue certainty of the system, each of the following could be fixed for a three- or five-year period: the tax shares assigned to the subnational government sector, the relative proportions allocated on a derivation and formula basis, and the distribution formula itself. Many countries have established grants commissions to develop proposals for grant formulas and sharing systems (Bahl and Linn 1992).

One might well ask what is the meaning of transfers in a system where all revenues are collected at the so-called grassroots level and transferred upward. Two elements should be remembered: these are national taxes, collected through the local deconcentrated arms of a national tax service. It is only by convention that localities think of these taxes as “theirs.” Practically speaking, revenues other than those

retained on a derivation basis by the oblasts would first flow up; those to be allocated on a formula basis would then flow down.

Tax sharing on a derivation basis

Under derivation sharing, a portion of major taxes in the distributable pool would accrue to the oblasts where they are collected, preferably with uniform rates of sharing across all oblasts. If 60 percent of subnational revenues were to be allocated on a derivation basis, all oblasts would receive a percentage from each tax in the revenue pool (the percentage of each tax could vary), with the percentages calculated to exhaust the 60 percent.

This structure would reward oblasts that attract and promote industry by giving them a greater flow of revenue. The uniform sharing rates would remove negotiation from tax-sharing determinations and give subnational governments a more dependable flow of revenue, thereby promoting more efficient budgetary planning. The advantage of this approach for Russia today is its similarity in concept to the existing system. Moreover, derivation sharing can be administered at relatively little cost, and unless the subnational shares in each tax differ widely, it does not give the State Tax Service an incentive to collect one tax more efficiently than another.

The derivation approach to revenue sharing is not without problems. The value added tax does not lend itself easily to derivation sharing, for example. Industrial provinces with a high VAT can have an advantage, and the zero-rating of exports can handicap oblasts whose enterprises sell to foreign markets, since they pay large export rebates. The VAT collected on imports would accrue fully to the port city. These outcomes, neither of which is sensible, could be dealt with only by means of a complicated set of border tax adjustments as goods crossed from one oblast to another (see the discussion of Ukraine, chapter 8). If these problems are not addressed, derivation sharing of the VAT could lead some oblasts to establish barriers to trade with other oblasts. This problem could be resolved by eliminating the VAT from that part of the revenue pool that is shared on a derivation basis. However, eliminating the VAT would make the common revenue pool more cyclical (the VAT is the most cyclically stable tax), and would require sharing rates of personal and corporate taxes to be set at high levels, possibly affecting State Tax Service collection incentives. On balance, the proper action would be to eliminate the VAT from any derivation sharing as soon as such a move is feasible.

Allocating the corporate tax on a derivation basis is also complex, since the origin of profits must be determined for multilocation enterprises. Are they levied where the headquarters is located? Where the sales took place? Where employment is located? Such determinations will increase the complexity of an already overburdened tax system. The current law allows the corporate income tax to be prorated by employment, but this may require modification. If the corporate income tax is to be shared with subnational governments by derivation, the central government must begin planning for the time when the profits of nationwide firms must be allocated among oblasts.

There are similar complications with excises—the most important being on vodka and cigarettes. Levied presently at the producer level, not the retail level, derivation based sharing effectively channels these excise taxes to the few oblasts producing excisable goods in Russia's monopolized industrial sector. Thus, while some portion could be shared this way, excises are better suited to formula-based sharing than to derivation sharing at present.

Formula-based revenue sharing

The remainder of the subnational revenue pool would be divided among oblasts on a formula basis. This arrangement would serve the same function as intergovernmental transfers in most countries. Since the revenues assigned to each level of government usually cannot be matched perfectly with their expenditures, transfers are used to supplement own or shared revenues so that subnational expenditures are adequately financed. Depending on the formula, it can be equalizing in the sense that resources are directed toward oblasts where fiscal capacity is relatively low or the level of need is great. This formula would also make revenue receipts for subnational governments more certain, and would help subnational governments plan more efficiently. In Russia one would envisage formula-based transfers to be channeled via the central budget, although the revenues would first flow upward, as at present, from the inverted system of tax administration.

What indicators should be included in the formula? In Russia the structure of the formula should be kept simple. In most countries that use this arrangement, the formula consists of some estimate of expenditure needs (often simply population), an assessment of revenues potentially available to finance these needs, and rules covering the reach of equalization. A rough construction would be $G = E - R$, where G is the grant, E is the expenditure needs (for example, based on equal per capita needs), and R is the revenue capacity (based on available own-source revenues, not actual revenues).¹³ This formula approach is very different from the current Russian approach, which simply seeks to bring all oblasts up to a fraction of average national per capita revenues.

One challenge in this approach is defining expenditure needs for each jurisdiction. Definitions should reflect needs based on population size, composition, or other indicators, as opposed to only the recurrent costs of financing existing facilities (capacity) under the current system since many of these facilities are oversupplied in some areas and absent in others. One approach might be to begin with concrete expenditure norms, and then to cost them out. In Russia this might be accomplished in principle by modifying existing expenditure norms to reflect actual population needs. For example, standardized classroom sizes in rural regions and cities would be multiplied by the standard cost of a teacher, classroom operation, and other factors to derive a cost figure in rubles. Performing this calculation for each expenditure function would itemize and build up the expenditure needs of each jurisdiction. While the precision of this approach has much appeal (it has been successfully applied in Australia and Denmark), it is far too complex. Even such countries as Canada have not felt able to attempt it. In addition, the high rate of inflation in Russia and the need for precise data would probably rule out this method.

A simpler approach would be based on umbrella variables, such as population, density, per capita income, city size, poverty rates, and the centrality of a city, to signify need and allocate budgetary resources accordingly. Other indicators, such as miles of substandard roads and deficiencies in school and hospital space, could also serve. Germany and the United States use such simple models to operate some of their grant programs (Bird 1986b).

The next step is to estimate the revenue capacity of an oblast. If only its actual revenue collections were considered, the oblast could reduce its tax effort to appear poorer and thus receive higher transfers. Subnational revenue capacity in Russia is a function of the size of the subnational tax bases, property and land values, number of vehicles, and number of businesses. Two approaches to measure fiscal capacity are possible. One estimates the yield of a representative tax system, as done for Canada.

Another approach is the regression method, which uses umbrella variables to capture the size of the base (Bird and Slack 1990).

The initial construction of any formula is inherently an arbitrary process. Establishing a grants commission to work on the ongoing design of the overall intergovernment system, to develop a formula on a consensus basis, and to monitor and coordinate ongoing reforms would be one way to address the problem (see chapter 1).

Russia's committee of regional, Ministry of Finance, and research experts, appointed in 1994 to investigate reforms of VAT sharing, is in this tradition. Establishing a commission to develop the data (for example, a census of governments) needed to support the ongoing monitoring and redesign of the intergovernmental system would also be a priority consideration.

Enhanced subnational taxes.

The fourth dimension of the framework would give subnational governments additional, but limited, independent taxing power. Making subnational governments accountable by giving them both tax and expenditure discretion is a crucial benefit of a decentralized system of fiscal relations. Three promising types of subnational taxing powers are a surcharge on the personal income tax (up to a limit prescribed by the federal government), a tax on land values within urban areas, and a tax on ownership and operation of motor vehicles. Another possible surcharge is on the corporate income tax. This could be more revenue productive but would raise problems because of interoblast competition; moreover, subnational governments may be unwilling to further increase taxes on local enterprises. Overall, this would be very much a second best choice.

The advantage of these taxes is that they place the burden on local citizens, thereby increasing the accountability of subnational officials. Moreover, the costs of complying with the taxes would be lower and their revenue potential would be greater than that of the twenty-one minor taxes proposed in the Basic Principles law and now accruing to local governments. While the burden of taxes on individuals is already high in Russia, the distribution of the burden imposed by these three taxes would probably be progressive, making them preferable to other, more regressive taxes. The property and vehicle taxes would require some investment in improved tax administration, and both would have to be collected by the State Tax Service, although the federal level would not share in their revenue. In the long run, subnational governments should probably have even greater revenue discretion, with greater rate- or base-fixing discretion over some major revenue sources. Arguably, subnational governments currently depend too much on shared central taxes and subventions.

In contrast, the twenty-one local taxes currently in place are likely to generate little revenue, strain the limited resources of the State Tax Service, and, most important, divert attention from the more productive revenue alternatives mentioned earlier. Many are nuisance taxes whose compliance costs slow down the workings of the local economy.

Intraoblast fiscal relations

A major unanswered issue for Russia is the scope of the intergovernmental system. Laws thus far have been silent on the matter. Should the fiscal structure define tax (and expenditure) assignment only to the oblast level and leave it to the oblast soviet to decide the distribution within its boundaries? Or should the intergovernmental system be structured to prescribe the exact allocation of fiscal resources to

oblasts, as well as to cities and rayons? Extending the system to the suboblast level would give the federal government maximum control over the regional distribution of resources, since tax collection and assessment and much of the expenditure delivery and budgeting actually take place below the oblast level. However, local affairs may be handled more efficiently by the oblast than by Moscow, especially in a country as large as Russia. The answers have a great deal to do with whether Russia sees itself as a federation or not.

Scope of the intergovernmental system

The oblast soviet, or government, is responsible for the allocation of financial resources among all the rayons and municipalities within the oblast.¹⁴ It determines the share of taxes each rayon and city may retain (and, by implication, the residual that is left for the oblast itself). It may choose to allocate an additional subsidy to rayon governments, thereby determining the spending level of each local government. In making these decisions about intraoblast fiscal relations, the oblast soviet faces some constraints:

- Tax rates and tax bases are fixed by the federal government and cannot be adjusted.
- Some minor taxes and charges are prescribed as fully rayon level.
- The rayon share of revenue from oil and other natural resources is specifically mandated in the April 1992 Law on Payments for Natural Resources (see chapter 10).

At present, within these constraints, allocation choices rest with the oblast governments, and some have opted to redistribute substantial amounts of revenues away from the urban centers to the less-developed rayons. It has become a contentious issue, and there have been calls for a federal formula that identifies the share of each local government, either to enhance the position of the rural rayons or to protect the larger revenue base of the cities.

An intraoblast intergovernmental system could in principle operate in three ways: one could create a traditional federalism where taxes are assigned to either the federal or the oblast level and the oblast could then decide on the distribution among the local governments; one could prescribe an exact allocation of fiscal resources to oblasts, cities, and rayons; or one could give general guidelines for distribution within the oblast.

There are several advantages to giving oblasts responsibility for their rayons' fiscal affairs. First, it removes the central government from fiscal decisionmaking concerning the revenue needs of thousands of local governments. Second, it makes oblast and rayon governments more accountable to the local population for fiscal decisions. Third, it is a step toward greater fiscal decentralization in that it brings government closer to the people.

This approach also brings problems, however. The federal government is less able to steer the allocation of resources to areas where it wishes to stimulate economic activity or upgrade services—should this be deemed necessary or desirable. In addition, disparities may be as great within oblasts as they are among oblasts, and the federal and local governments may not share the same equalization goals. Moreover, the federal government may want to use incentives to stimulate local revenue effort, but cannot do so independent of oblast policy because tax administration efficiency is influenced at the local government level.

Disparities among rayons

Wide variations in economic well-being and fiscal capacity exist within each oblast, and oblasts must make difficult decisions about fiscal equalization. The oblast soviet could simply extend the central-oblast revenue-sharing scheme, that is, the derivation principle, but this would exacerbate the economic disparities among its own local governments. For example, within the Riazan oblast, which has thirteen rayons and two cities, per capita expenditures were more than three times larger in the highest-spending locality than in the lowest. In the first half of 1992, per capita expenditures were 50 to 100 percent greater in the cities of Riazan (the oblast capital) and Skopin than they were for the average of all Riazan oblast's rayons. In Cheliabinsk oblast, the per capita retained revenue in the rayons varied by 300 percent from highest to lowest in 1992.

Such disparities have led oblast governments to enact equalization features in their revenue-sharing systems, but some of these efforts have caused conflicts with better-off rayon governments, who believe they are unduly discriminated against. The situation is made more complex by the many unmet public service needs and poor infrastructure maintenance in even the better-off urban areas. Currently, some oblast governments have opted to use flat-rate tax sharing, which is counterequalizing, along with equalizing subventions.

Intraoblast disparities raise a problem for central government policy: Are variations in population and the average wage greater within oblasts than among oblasts? In the case of Cheliabinsk, this is true for population but not for average wage level. But disparities in per capita revenue collections and in the ratio of collections to income are greater within the oblasts than among them. Fiscal equalization, therefore, is as much an intraoblast as an interoblast issue.

Can federal policy be offset by oblast policy? The multiple regression that was reported in table 9.8 (column 1) shows a bias in the retention rate against urban areas, while the bias in Cheliabinsk oblast (column 3) favors urban communities (Bahl and Wallace 1994). This indicates that the oblast takes more of an interest in revenue stimulation than in equalization, at least with regard to the tax-sharing formulas it designs.

Revenue-raising efforts

The need to equalize may tend to dampen efforts to increase the rate of revenue mobilization. The State Tax Service staff at the local level is closely linked with the local government (rayons and cities), and assessment and collection efforts at the local level may be less successful or less vigorous if the local community knows it will not receive an adequate return from its increased revenue effort.

These issues point to an underlying concern: oblast soviet decisions may not reinforce central government economic policy. Suppose the central government decides to base its economic growth strategy for the next ten years on the development of urban centers and on those industries that require skilled labor and infrastructure.

Under the current system, the central government could not implement this strategy easily. The oblast soviet could still choose to direct resources toward rural areas, and could determine the budgetary allocations to education and infrastructure as it pleased. In truly decentralized systems such as Switzerland, the central government loses considerable control over the implementation of such overall

economic strategies. While not necessarily a negative thing, it illustrates the complexities of systems with strong local governance.

Bahl and others (1993) analyzed fiscal outcomes in Cheliabinsk oblast. They regressed per capita retained revenues in the oblast against a set of fiscal capacity and needs variables for thirty-eight suboblast-level governments. Their analysis showed that more than half the variation could be explained and that per capita revenues were significantly higher for local governments with larger populations and greater urban concentrations (see again table 9.6, column 3).

Income and needs variables were not significant determinants. Much the same analysis was carried out for the federal level, which showed a similar bias toward oblasts with larger populations, but there was a negative relationship with urbanization (table 9.6, column 1). This evidence may indicate that federal and oblast-level intergovernmental fiscal policies are not in sync. This, of course, is the essence of decentralized decisionmaking, and were Russia to see itself truly as a federation, the differing objectives would be of little concern. However, the central interest over local affairs remains significant.

Options for intraoblast finance

The analysis suggests that federal-subnational fiscal relations should not go below the oblast level. There are two reasons for this. First, this would imply a federal program that purports to equalize, in one effort, among 89 oblasts and more than 2,000 rayons. Second, such an approach would have to apply the same formula to all suboblast equalization nationwide. A better route would be to leave the distribution to each oblast. Moreover, if Russia sees itself as a federation, such center-rayon relations would be inappropriate. In sum, the federal government should concentrate its efforts on finding a proper relationship with its oblasts and regions, and leave intraoblast matters to the subnational councils.

It may be that some “framework law” is appropriate, in which oblasts are required to pass through some proportion of the revenues they receive downward to the rayon or city level, according to some agreed guidelines. One alternative is to specify guidelines, for example, for the minimum amount of the tax sharing that must be passed through to the local governments and by what criteria. Other options could include various center-oblast conditional grant mechanisms. This would seem to be a compromise that reconciles decentralization objectives with the center's desire for some influence over intraoblast affairs.

Conclusion

The budget for 1994 incorporates some of the reforms discussed in this chapter. Although all taxes are still shared on a derivation basis, the budget calls for formula-based subventions. As mentioned, the subventions will come from a fund made up of 22 percent of the federal government's share of the value added tax. Subventions accrue to low-revenue subnational governments based on the amount by which their per capita revenue falls below the average per capita revenue for all subnational governments. This may have a negative impact on the incentives for subnational governments to collect revenue—oblasts with per capita revenues that are just below average and oblasts with per capita revenues that are far below average both end up with the same overall per capita revenue (the average) after the subvention. Since the fund is made up of 22 percent of total federal value added tax collections, there may be some incentive for subnational tax officials to collect the tax effectively. If the value added tax fund is too small, however, they may not get enough. The 1994 budget also allows for some revenue discretion by authorizing a few local taxes to be levied independently.

Nonetheless, the intergovernmental fiscal system in Russia remains in a period of transition. The unstable economy is pushing policymakers in the direction of a more centralized fiscal system better able to support macroeconomic policy, while strong political forces underscore the inevitability of fiscal decentralization. The compromise since 1992 has been to redefine the system continually and in a variety of ways to disguise the centralizing and decentralizing trends.

This analysis points to five general conclusions. The first is that tax structure, tax administration, and revenue sharing are equally important components of the intergovernmental fiscal system: alter any one of the three and the impact of the system may change significantly.

Second, the absence of a concrete, legislated assignment of expenditure responsibilities is the greatest obstacle preventing Russian intergovernmental relations from moving away from the bargaining mode inherited from the old regime. Until expenditure responsibilities are assigned distinctly and explicitly, subnational budgets will be highly unpredictable. Without precision and fixity, it is not possible to design a stable revenue system that adequately finances the subnational sector. Are oblasts expected to finance all capital investments in transport and infrastructure? The decision will determine whether incremental revenues equivalent to 2 percent of GNP need to be channeled to them. The reality of negotiated and shifting expenditure responsibilities and negotiated spending norms is in stark contrast to the explicit tax assignments in the proposed Law on the Basic Principles of Taxation and other recent legislation. By focusing policy efforts exclusively on tax assignment and revenue-sharing mechanisms, the Russian government is putting the cart before the horse.

Third, the shift to a tax assignment system may be inevitable, but the time is not yet right for such a change. Traditions of subnational government finance are not in place to a degree that will allow for the absorption of full local autonomy, and income disparities among oblasts are so great that decentralization will have to be accompanied by an equalizing grant system. Moreover, there is the problem of tax administration. A tax assignment approach would require separate central and local tax administrations to collect taxes effectively at each level.

Fourth, the net fiscal impact on subnational budgets of the privatization and decentralization of enterprise ownership is unclear. While the sale of assets may lead to revenue inflows, the burden of providing subsidies will now fall on local budgets. In addition, privatization will result in a shift of social spending responsibilities from enterprises to local governments. Both need to be accommodated in the new system's design.

Finally, many of the fiscal tensions between the central government and the oblasts are replicated in the relationship between the oblasts and the rayons. Disparities within oblasts may be as large as the disparities among them. This has policy implications as well. If the oblasts have different goals than the central government, the effectiveness of federal fiscal policy on growth and equalization weakens.

The lack of clarity in the current system does not give the central government true control over fiscal policy, nor does it provide subnational governments with adequate means to meet their increasing expenditure needs. During this time of transition, Russia needs to implement a transparent fiscal system that promotes stability and equalization while permitting the subnational level some discretion. The reforms suggested here are a mix of derivation-based sharing, formula-based sharing, and enhanced assignment of subnational taxes. In 1994 there was a small but promising movement toward such a system. But a clear and precise codification of expenditure assignment is still needed.

Annex 9.1 Tax assignments: Law on the Basic Principles of Taxation

The Basic Principles law, passed in December 1991, was never fully implemented, notably with respect to federal and subnational taxes.¹⁵ However, it governs intergovernmental relations in many important ways.

Federal taxes.

These taxes accrue fully to the federal level and the federal government has full control over the base and rate of these taxes. They include:

- Value added tax
- Export taxes
- Excises on all items except motor vehicles and alcohol (50 percent local)
- Tax on bank profits
- Tax on insurance profits
- Tax “exchange activities”
- Tax on securities operation
- Customs duties
- The natural resource tax (shared 20/80 or 40/60 by the federal and subnational levels).

Shared taxes

The regulating revenues of subnational governments include two federal taxes. Oblast governments have no control over the base or rates of these taxes:

- Personal income tax
- Corporate income tax
- 50 percent of vodka excises and 100 percent of all other excises except motor vehicles

Subnational taxes

Subnational governments receive all of revenue from the collection of their own taxes:

- Road fund taxes
- Stamp duty
- Estate duty
- Gift tax and inheritance tax
- In addition, there are oblast level taxes. The center defines the base of these taxes; oblasts have some control over the rate (within a ceiling) and receive all of the revenues:

- Property tax/asset tax on enterprises
- Forestry tax
- Payment for water use

Rayon/local taxes

Rayon and local-level taxes include twenty-one taxes and fees, some of which are best thought of as nuisance taxes. Their base and rate can be set locally, but the law has set maximum rates for most of them:

- Property tax on natural persons
- Land tax
- Business registration fees
- Construction in resort areas
- Resort fee
- Tax on the right to trade
- Special purpose taxes for such uses as maintenance of the militia
- Tax on advertising
- Tax on the resale of cars and computers
- Tax on owners of dogs
- License fee for the sale of wine and liquor
- License fee for the right to hold auctions
- Fee to move into apartments
- Fee for car parking
- Trademark fee (use of logos)
- Fee to participate in horse races
- Fee on winnings at horse races
- Fee on participating in the “totalizer game” at races
- Fees for commodity exchange transactions
- Fee on filming for cinema and TV
- Fee for cleaning settlements

Table A9.1 Oblast tax effort and tax capacity, Russian Federation, 1992

<i>Oblast</i>	<i>Shared tax collections as a percentage of GVIO (1)</i>	<i>Estimated taxable capacity (2)</i>	<i>Tax effort ration (1 ÷ 2)</i>	<i>Tax effort ranking</i>
Ivanov	34.9	13.8	2.53	1
Kalmytskaya AR	140.0	78.3	1.79	2
Yakutskaya AR	88.1	66.3	1.33	3
Kostroma	70.8	55.6	1.28	4
Komi AR	74.8	58.8	1.27	5
Vladimir	40.9	32.6	1.25	6
Vologda	44.3	36.6	1.21	7
Amurskaya	95.3	79.1	1.21	8
Gorki	45.2	37.6	1.20	9
Cheliabinsk	34.9	29.2	1.20	10
Kuibyshev	40.4	33.9	1.19	11
Krasnoyarsk Krai	45.2	38.4	1.18	12
St. Petersburg (city)	57.4	49.4	1.16	13
Tatarskaya AR	44.0	38.4	1.15	14
Novgorod	63.4	58.3	1.09	15
Moscow	41.9	38.6	1.09	16
Yaroslavl	39.7	36.6	1.08	17
Lipetsk	43.0	39.8	1.08	18
Orenburg	47.2	43.9	1.08	19
Kursk	53.1	49.7	1.07	20
Baskirskaya AR	39.7	37.6	1.06	21
Kemerovo	55.2	52.5	1.05	22
Riazan	40.7	38.8	1.05	23
Perm	48.2	46.1	1.04	24
Tomsk	67.7	64.9	1.04	25
Karel AR	63.2	60.9	1.04	26
Chita	81.3	78.8	1.03	27
Astrakhan	69.7	67.9	1.03	28
Chuvaskaya AR	50.1	49.3	1.02	29
Smolensk	52.4	51.6	1.01	30
Kirov	56.1	55.7	1.01	31
Mirdovskaya AR	55.9	55.6	1.01	32
Leningrad	44.8	44.6	1.00	33
Krasnodar Krai	52.8	52.7	1.00	34
Rostov	48.8	48.8	1.00	35
Belgorod	55.0	55.5	0.99	36
Sakalinskaya	55.7	56.5	0.99	37
Orlov	50.2	51.0	0.98	38

<i>Oblast</i>	<i>Shared tax collections as a percentage of GVIO (1)</i>	<i>Estimated taxable capacity (2)</i>	<i>Tax effort ration (1 ÷ 2)</i>	<i>Tax effort ranking</i>
Bransk	47.8	49.1	0.97	39
Omsk	44.9	46.2	0.97	40
Buriatskaya AR	64.5	66.6	0.97	41
Mariysaya AR	61.3	63.7	0.96	42
Pskov	59.1	62.1	0.95	43
Volgograd	42.8	45.3	0.95	44
Tambov	49.4	52.4	0.94	45
Kamchatskaya	55.3	60.0	0.92	46
Altay Krai	48.1	52.6	0.91	47
Kurgan	52.3	57.9	0.90	48
Tula	41.0	45.7	0.90	49
Vorosezh	45.1	50.3	0.90	50
Penza	50.5	57.2	0.88	51
Stavropol Krai	46.9	53.9	0.87	52
Saradov	47.5	55.1	0.86	53
Udmurdszkaya AR	42.6	49.4	0.86	54
Ulianovsk	40.5	47.5	0.85	55
Novosibirsk	48.0	57.6	0.83	56
Severo-Osetinskaya AR	50.7	62.3	0.81	57
Arkhangelsk	48.7	59.9	0.81	58
Kaluga	46.8	58.7	0.80	59
Khabarov Krai	44.3	57.4	0.77	60
Magadan	43.6	57.2	0.76	61
Kabaldino- Balkarskaya	44.4	59.7	0.74	62
Dagestanskaya AR	46.7	65.3	0.71	63
Murmansk	38.1	53.4	0.71	64
Tyumen	15.1	22.0	0.69	65
Checheno-Inkuskaya AR	37.6	57.4	0.65	66
Kaliningrad	24.9	50.8	0.49	67

GVIO Gross value of industrial output.

AR Autonomous republic.

Source: Bahl, in Wallich 1994; estimates based on data supplied by the Ministry of Finance of the Russian Federation.

Notes:

¹ This chapter draws on Wallich (1994).

² Throughout this chapter, references to the “oblast level” include constituent republics of the Russian Federation, krais, okrugs, regions, and national areas. The term “subnational” refers to all levels below the federal or central level. The “local level” refers to cities and rayons and below.

ⁱⁱⁱ This section draws heavily on Martinez-Vazquez (1994b) and on Wallich (1994). Martinez-Vazquez has also written a series of papers on expenditure assignment and budgeting in Russia that provide information about how the system works and what its failings are. See also Martinez-Vazquez (1994d).

⁴ In January of 1994 inflation rates were 17.9 percent and in February, 10.7 percent. Inflation in March was notably low at 7.4 percent, compared with an average monthly rate of 21 percent in 1993. (Data are from Goskomstat, IMF, and World Bank.)

⁵ This is based on Ministry of Finance of the Russian Federation and IMF staff calculations.

⁶ Subnational deficits can be monetized in the soft budget environment that currently prevails for enterprises, and for banks, whose credit or liquidity demands may be accommodated. Arrears may also be monetized in the course of arrears clearance exercises.

⁷ The proposed Law on the Basic Principles of the Budget System and Budgetary Process gave subnational governments the right to receive loans from higher-level governments or to receive commercial loans.

⁸ The Law on the Budgetary Rights of Local Self-Government (June 1993) and the Law on the Rights of Local Self-Governments (1992).

⁹ Bahl and others (1993) compiled an exact list of the services provided and attempted to measure the cost to the enterprise in each case.

¹⁰ The Law on the Budgetary Rights of Local Self-Government (June 1993) and the Law on the Rights of Local Self-Governments (1992).

¹¹ In Russian terminology a regulating revenue is a revenue shared between government levels to regulate the revenue retained by the lower level and to ensure that the lower level achieves a budget balance.

¹² See IMF (1992a, 1992b), Lotz and Morss (1967), and Chelliah (1971).

¹³ See the annex to chapter 2 for an example in the Hungarian case.

¹⁴ The Riazan case study reported here is taken from Bahl (1994), and the Cheliabinsk case study from Bahl and others (1993).

¹⁵ Annex 9.1 is based on information from the Ministry of Finance of the Russian Federation.