

## Institutions of the Russian fiscal federalism: 20 years of evolution BY ELENA JAROCIŃSKA

### Introduction

The 1993 Constitution followed by post-constitutional reforms and amendments provide the regulatory framework for the functioning of fiscal federal institutions in Russia. The Russian federal state is structured in four layers: 1) federal 2) 83 regions; 3) 518 larger cities (“gorodskoi okrug”) and 1,817 municipalities (“raions”); and 4) 20,409 settlements (“poselenie”)<sup>1</sup>. Russia’s degree of fiscal decentralization is comparable to other federal countries (see Table 1).

As measured by the share of sub-national governments in general government spending and revenues, the degree of decentralization is somewhat lower than the average of federal countries listed in Table 1. In addition to public finance data, the degree of fiscal autonomy of subnational governments depends on whether they can set the standards of public spending and determine tax rates and tax bases. I discuss these issues below.

In this brief, first I summarize the main thrust of Russian federal fiscal institutions and discuss their specific features. Second, I describe the evolution of federal fiscal regulations since the establishment of the Russian federal state. Third, I conclude. The main policy recommendations are the following: tax autonomy of subnational governments

which is currently very limited should be increased; federal aid should be further formalized and made more transparent; regulations should not be changed from year to year to provide for a more stable environment; and subnational interests should be better protected at the institutional level.

### The main thrust of the federal fiscal institutions

The main thrust of the federal fiscal institutions can be summarized as follows. Federal fiscal legislation assigns spending mandates to sub-national governments in the areas of education, health, social protection, housing development, etc<sup>2</sup>. Fiscal legislation specifies the revenue sources of subnational governments for their spending mandates, mainly shares in federal taxes, grants from the federal level and some regional taxes. Subnational governments can decide on the rates and exemptions in tax sharing and regional taxation but only within limits set by the federal law. In effect, the legislation seriously constrains the tax autonomy of subnational governments.

Subnational governments are provided with the formula-based equalization grants that reduce the existing large

**Table 1. Indicators of fiscal decentralization in federal countries**

	Sub-national government, 2012	
	Share in general government spending <sup>1</sup>	Share in general government revenues <sup>2</sup>
Russia	36.5	27.9
Austria	30.5	24.8
Germany	38.7	34.9
Mexico	45.3	9.6
Switzerland	57.9	47.6
United States	47.3	45.4
Average	42.7	31.7

Source: Russia - author’s calculations based on data from the Ministry of Finance; other countries - OECD Fiscal Decentralization Database.

<sup>1</sup> Excluding the transfers paid to other levels of government.

<sup>2</sup> Excluding transfers received from other levels of government.

<sup>1</sup> Rosstat, 2013. Note that only municipalities are subdivided into settlements.

<sup>2</sup> I discuss the evolution of particular laws on expenditure and tax assignment below in the next part.

differences in tax capacity across Russian regions.

In addition to equalization grants, the regulations provide for other grants to subnational governments that are needed to finance spending mandates and other expenditures.

Given that in Russia revenues of the federal and subnational governments depend to a large extent on the price of oil, an important block of the federal fiscal legislation is the stabilization policy. The Reserve Fund, which was established in 2003, cushions the effect of oil price fluctuations on the budget. In addition to the Reserve fund, Russia has a fiscal rule that ex ante caps federal government expenditures at a certain level which is determined by a five-year average of past oil prices. Fiscal legislation also establishes limits on deficits, debts and borrowing of sub-national governments.

Experts agree that Russia has a modern legal framework of the budget process<sup>3</sup>. It has three-year budgets, which provide predictability in terms of public spending and considerable constraints on the extra-budgetary activities of government units (see e.g. Kraan et al., 2008). A Single Treasury account, held at the Treasury, forbids all cash holdings in domestic currency by government agencies outside this account. The Treasury system executes payments, controls and monitors the budget process. The Central Bank and the Accounts Chamber are seen as independent (IMF, 2004). However the Constitutional Court is seen to protect the federal center in the rulings on federal fiscal issues. Between 1995 and 2004, the Court rarely supported any expansion of the rights of the regions vis-à-vis the federal center (Trochev, 2006).

All budgetary laws should be examined by the second chamber of the Parliament – the Federation Council. The Federation Council, which is supposed to protect regional interests, is in effect defending federal interests. The Federation Council approved a number of political and fiscal federal initiatives that have substantially reduced the bargaining power of regions: governors and speakers of regional parliaments were excluded from membership in the Federal Council; popular elections of governors were removed and instead since 2004 governors have been selected by the President<sup>4</sup>; the second chamber approved amendments that abolished a number of regional and local taxes.

What is specific about the Russian federal fiscal framework? First, regulations are mainly set at the federal level. Taxes, regardless of whether they are federal, regional or local, are based on federal laws. The federal government controls key matters of the spending assignment regulation. A considerable part of grants to sub-national governments (about half of the grants in years 2005-2007 according to De Silva et al. (2009)), is not formula-based and is at the discretion of the federal government. Studies have shown that discretionary grants in the nineties were used by the federal center to increase its re-election probabilities (e.g. Jarocinska, 2010). There is some evidence that discretionary grants are still being used by the federal government for political purposes (De Silva et al., 2009).

Second, the federal fiscal regulatory framework is frequently changing. In recent years, after the major reforms had already been carried out, the federal government has often changed the allocation of tax revenues, expenditures and transfers. There are around two hundred types of earmarked grants and they change from year to year. This creates a very unpredictable environment for subnational budgets and makes it difficult to forecast revenues and expenditures.

## The evolution of the federal fiscal institutions

### *The regulatory framework*

The Constitution of 1993 laid down the founding principles of the Russian federal fiscal framework. Within the federal structure, the Constitution distinguishes two levels of government – federal and regional<sup>5</sup>. Formally, local governments are independent authorities that are not subordinate to the regional governments<sup>6</sup>. In practice, local governments depend financially on higher-level government. The Constitution specifies the areas of exclusive jurisdiction at the federal level and the areas of joint jurisdiction with regional governments, establishes the independent Central Bank and the independent audit institution – the Accounts Chamber, provides

<sup>3</sup> See e.g. IMF, 2004 and Kraan et al., 2008.

<sup>4</sup> The popular elections of governors were reintroduced in 2012, although the election procedure has become more complicated for independent candidates.

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<sup>5</sup> Chapter 3 of the Constitution.

<sup>6</sup> Chapter 8 of the Constitution.

for a Constitutional Court, and contains the rules on constitutional amendments.

The Constitution is rather vague with respect to federal fiscal regulations. The areas of revenue and spending assignment, regional redistribution, stabilization policies and numerical fiscal rules are not discussed in the Constitution.

The other main laws that regulate federal fiscal relations in Russia are listed in Table 2. The evolution of federal fiscal institutions can be divided into four distinct periods.

**Table 2. Main laws regulating federal fiscal relations in Russia**

Year of Adoption	Years of main amendments	Title
1993		Constitution of the Russian Federation
1995	2003	Federal Law N154 On General Principles of the Organization of Local Self-Government
1998	2003, 2004, 2007	Budget Code
1998 (Part I) and 2000 (Part II)		Tax Code
1999	2003	Federal Law N184 On General Principles of the Organization of Government in Subjects of the Federation

### ***Spontaneous decentralization, 1991-1993***

With the dissolution of the Soviet Union in 1991, the federal government delegated many social expenditures to the regional level. In response, regions lobbied for larger shares of tax revenue and transfers. The federal laws that regulated fiscal relations at that time were often not respected by the regional authorities. Tax assignment was mainly determined by bilateral agreements between the federal center and the regions and annual negotiations. By 1996, 24 bilateral agreements had been signed, with some of the regions sending no tax revenue to the federal center (De Silva et al., 2009). These bilateral agreements contradicted the provision of the Constitution that all regions should have equal status.

### ***Formalization of rules, 1994-2002***

In the next period, federal fiscal regulations were formalized and made uniform across regions. The new Constitution of 1993 strengthened the role of the federal center in fiscal relations with the regions, which was essential for the enforcement of federal laws. The leverage of the center over regional governors and administrations was further increased through new legislation passed in 2001 that authorized the removal of regional governors by the President in the event of repeated violations of federal laws (OECD, 2002). Better enforcement of federal laws was also ensured through the establishment of seven macro-regions, headed by powerful presidential envoys introduced by a Presidential decree in 2000<sup>7</sup>.

In 1995, the Federal Law N154 on General Principles of the Organization of Local Self-Government ("Law on Local Self-Government") defined the status of local governments and established a list of spending mandates, which was a first attempt to assign spending mandates to local governments. The 1994 federal budget prescribed uniform sharing rules for federal taxes, although several regions maintained individual sharing rates until the late nineties. The 1994 federal budget also introduced the equalization formula that narrows the large differences in fiscal capacity among Russian regions. In the 1999 federal budget the equalization formula was reformed to include indicators of tax capacity and expenditure needs, which was an important development in creating the right incentives for regional authorities. Until 1999, the amount of equalization transfers depended on actual revenues and expenditures of regions, so regions were trying to understate their revenues and inflate expenditures in order to get larger transfers.

<sup>7</sup> Presidential decree N849 of 2000 on Presidential Envoys in Federal okrugs.

The Budget Code was adopted in 1998 and entered into force in 2000. The Budget Code sets out the contents of the annual budget laws, defines the jurisdictions of the federal and regional governments and regulates their financial relations, prescribes the annual budget preparation and execution time schedule, and lays down rules for public debt (Kraan et al., 2008). Until 1998, debt regulations were mostly absent. In the second half of the 1990s, the budget deficit was rather high in each region, and in many regions it reached 50 percent of revenues, including transfers (Kurlyandskaya, 2013). As a result of the 1998 crisis, between 1998 and 2001, 57 of 89 Russian regions defaulted on their debt obligations (Kurlyandskaya, 2013). According to the Budget Code, for regions and municipalities, the deficit should not exceed 15% of the total annual own budget revenue, and debt should not exceed total annual own budget revenues (exclusive of grants)<sup>8</sup>. For regions and municipalities that have received grants that exceed 60% (regions) and 70% (municipalities) of their own budget revenues during two of the last three years, the debt is reduced to 50% of annual own budget revenues and the allowed deficit should not exceed 10% of total annual budget revenue (regions) and 5% (municipalities)<sup>9</sup>. The Federal Ministry of Finance carefully monitors the debt and deficit parameters of regional governments and imposes sanctions - for instance, the suspension of intergovernmental grants when the limits are breached (Kraan et al. 2008). Regions rarely breach numerical fiscal rules (De Silva et al., 2009).

Spending mandates of regional governments are further specified in the Federal Law N184 on General Principles of the Organization of Government in Subjects of the Federation ("Law on Regional Government") that was adopted in 1999. In 2000-2001, the Russian government introduced a major tax reform with the adoption of the Tax Code. The Tax Code assigned taxes across federal, regional and local levels and prescribed tax shares for the federal and regional levels. Regions are allowed to reduce the sharing rate for the corporate income tax up to a certain level. Regions can also reduce the tax rate for the regional property tax within the ceilings set in the Tax Code and introduce certain

tax exemptions. To solve the problem of unfunded federal mandates in the area of social protection, the federal government provided earmarked funds for their financing<sup>10</sup>.

### ***Major reform of subnational finances, 2003-2008***

In 2003-2008, subnational finances were thoroughly reformed. Major revisions of the Budget Code were enacted in 2003 and 2004. The revision of 2003 established the Oil Stabilization Fund that was later split into the Reserve Fund and the National Wealth Fund<sup>11</sup>. The revision of 2004 clarified and reassigned spending responsibilities across different levels of government, fixed tax shares of the federal taxes, and prescribed fiscal rules for subnational governments. In addition, the equalization formula was introduced in the Budget Code rather than determined annually in the budget laws<sup>12</sup>. Several subnational taxes, including housing and utilities tax and sales tax were abolished, reducing the share of own revenues in subnational budgets. The lack of taxation powers created the wrong incentives for subnational governments to increase spending while relaxing their tax effort, thereby making such governments even more dependent on transfers from the central government (De Silva et al., 2009).

The 2007 amendments to the Budget Code tightened fiscal limits for highly subsidized regions and imposed a number of restrictions on their budget process. Regions with a share of grants exceeding 60% (excluding subventions) were obliged to: conclude an agreement with the Ministry of Finance on how to increase the efficiency of the budget expenditures, run special accounts in the Federal Treasury, and have an external audit by the Accounts Chamber every year<sup>13</sup>. These restrictions were aimed at encouraging regions to develop their own tax bases and to improve fiscal discipline (Kraan et al., 2008). In practice, new restrictions resulted in the stronger interference of the federal center in regional budget processes. Starting from the budget year 2008, Russia formulates

<sup>8</sup> Articles 92.1 and 107 of the Budget Code.

<sup>9</sup> Article 107 of the Budget Code.

<sup>10</sup> Unfunded federal mandates are expenditures under federal responsibility that were delegated to the sub-national level without providing sufficient financing.

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<sup>11</sup> Articles 96.1, 96.9 and 96.10 of the Budget Code.

<sup>12</sup> Article 131 of the Budget Code and Government Resolution N670 of 2004 on Allocation of Equalization Grants to Regions of the RF.

<sup>13</sup> Article 130 of the Budget Code.

three-year budgets, a budget of the current year and a budget for a two-year planning period.

In 2003, the government radically reformed the local level with the adoption of the new version of the Law on Local Self-Government. It introduced the four tier federal structure and reformed the assignment of expenditures. Despite the formal assignment of expenditures across levels of governments, until 2005 not a single expenditure function was assigned to one level of government (De Silva et al. 2009). The reform of local governments consisted of amending 152 federal laws regulating particular aspects of the provision of public goods and repealing 41 federal laws, including amendments to the Law on Regional Government and Budget and Tax Codes (De Silva et al. 2009). As a result, the enactment of the new law was postponed until 2009. It appears that the local government reform has led to substantial decentralization from the regional level to the local level. This can be seen from the budget execution reports of regional governments which show large differences in the provision of public services (De Silva et al., 2009). However, the expenditure autonomy of local governments is constrained by binding national standards and norms.

#### **Anti-crisis policies, 2009-2012**

Recent changes in the legislation have been mainly implemented in response to the economic crisis of 2008. The government has amended the Tax Code and the Budget Code in order to contain the effects of the crisis on subnational finances. Subnational governments have received additional tax revenue sources: 0.5 percent of the tax share in the corporate income tax and higher shares on certain excise taxes<sup>14</sup>. Regional budgets were also supported with additional general purpose grants. Subnational budgets also received a large amount of federal loans that have lower interest rates and a longer repayment period. Limits on subnational deficits and debts were eased through 2017<sup>15</sup>. As a result of these anti-crisis measures, none of the subnational government defaulted on their debt obligations in 2009.

In 2012, the government introduced a new fiscal rule that ex ante caps federal government expenditures at the projection of the sum of non-oil revenues, oil

and gas revenues calculated at a benchmark oil price, and net financing of one percent of GDP<sup>16</sup>. This rule replaced an existing (but suspended since the 2008 crisis) budgetary rule targeting a nonoil deficit of 4.7 percent of GDP (OECD, 2014). According to the IMF (2013), the new fiscal rule helps contain spending pressures and smooth volatility, but is insufficient to rebuild fiscal buffers.

The following main trends of the Russian federal fiscal institutions can be outlined from the above discussion.

- *More decentralization of spending assignment:* reforms have led to substantial decentralization from the federal to regional and local levels. However, the expenditure autonomy of local governments is constrained by binding national standards and norms.
- *Stronger legal anchoring of equalization grants:* the formula for equalization grants have been introduced to the Budget Code.
- *Stricter fiscal rules:* in response to common defaults of regional governments after the 1998 crisis, the government introduced limits on the deficits, debts and borrowing of sub-national governments. Sanctions can be imposed (for instance, the suspension of intergovernmental grants) when the limits are breached.
- *Stronger interference of federal government in the regional budget processes of highly subsidized regions:* Regions with a share of grants exceeding 60% have a number of restrictions on their budget process.
- *Less power of the second chamber:* governors and speakers of regional parliaments were excluded from membership in the Federal Council.

#### **Conclusion**

In this brief, I describe the main thrust of the Russian federal fiscal institutions and discuss their historical evolution. The rules that guide decision-making in the area of fiscal policy and in particular in fiscal relations between the federal and subnational levels of government are laid out in the Constitution

<sup>14</sup> The Federal Law N305 of 2008 on the Amendments to the Tax Code.

<sup>15</sup> The Federal Law N58 of 2009 on the Amendments to the Budget Code.

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<sup>16</sup> The Federal Law N268 of 2012 on the Amendments to the Budget Code.

of 1993 and are further detailed in the post-constitutional legislation.

Since 1993, the Russian federal fiscal legislation has been substantially improved and modernized. It provides for clear tax and revenue assignment, formula-based equalization grants, strict numerical rules and a modern budget process. However, a number of features still need to be improved. The legislation seriously constrains the tax autonomy of subnational governments and allows for large discretion in the allocation of intergovernmental grants. The lack of taxation powers creates wrong incentives for subnational governments to increase spending while relaxing their tax efforts. Discretionary federal aid is often not transparent and is likely to be used by the central government for political purposes. In addition, regulations are mainly set at the federal level and are frequently changing. Moreover, the fiscal legislation does not ensure the protection of subnational interests at the institutional level.

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