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The review provides a detailed analysis of main trends in Russia's economy in 2008. The paper contains five big sections that highlight single aspects of Russia's economic development: the socio-political context; the monetary and credit and financial spheres; the real sector; social sphere; institutional challenges. The paper employs a huge mass of statistical data that forms the basis of original computation and numerous charts.

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Anton Siluanov, Pavel Kadochnikov, Vladimir Nazarov, Arseny Mamedov

Intergovernmental Relations and Subnational Finances in Russia in 2008

2.3.1. Major Trends in Relations between Budgets of Different Levels

Major trends in the relations between governments of different levels are reflected in the structure of revenues and expenditures of the RF consolidated budget. *Table 19* presents the data, reflecting the share of tax revenues and expenditures of the Russian Federation Subjects in the relevant indicators of the Russian consolidated budget.

Table 19

**The Share of Some Indicators of Budgets of the Federation Subjects
in the Consolidated Budget of the Russian Federation in 1992–2008 (%)**

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Tax revenues	44.2	53.1	53.4	47.6	49.5	53.1	56.6	49.2	43.5	37.4	35.1	39.6	36.1	30.9	31.8	33.9	33.2
Expenditures	34.0	40.3	37.7	43.4	45.4	48.1	54.1	51.9	54.4	54.2	49.3	50.0	50.8	49.5	43.4	48.3	49.2

Source: Federal Treasury, IET estimates.

Reviewing the data of *Table 19*, one should note the following. During the period of 1999-2005, a significant centralization of tax revenues was observed, while the share of this type of revenue of the Russian Federation Subjects in the consolidated budget has decreased from 56.6% to 30.9%. At the same time, in 2006-2007 that indicator started to increase slightly, what reflected some adjustment of the trend towards centralization of tax revenues. It should be noted, that this adjustment was not due to the relocation of tax sources between the levels of budgetary system, but rather due to the more rapid growth of tax revenues allocated to the regional budgets, as compared with tax revenues of the federal budget. In 2008, this share has somewhat decreased, but still remained at a significantly higher level than the indicator of 2005. Herewith, the share of regional expenditures in the consolidated budget of the Russian Federation continued its upward trend, approximating the indicators of 2002-2005.

There were no significant changes in the structure of tax revenues of the RF Subjects. As before, still more than half of tax revenues are obtained from two types of taxes: corporate profit tax (the share has decreased by 2.4%, to the amount of 40%) and personal income tax (its share in the total tax revenue, by contrast, has grown from 35% in 2007 up to 38% in 2008). The share of these taxes in tax revenue in the budgets of the Russian Federation Subjects has not changed and amounted to 78% (against 77.3% a year earlier). Analysis of the basic tax revenues in terms of GDP share allows to note the following (see *Table 20*). Proceeds from personal income tax continued the trend of increasing, having reached 4.0% of GDP (3.8% in 2007). Corporate income tax revenue has demonstrated a slight decline from 4.6% to 4.2% of GDP. Regional budget revenues, generated by excise taxes, in the past year (as in a number of preceding years) have decreased and reached 0.46% of GDP (0.54% in

2007). Property tax share has somewhat decreased (from 1.25% to 1.19% of GDP). At the same time, the growth was recorded in regard to royalty on natural resources, from 0.23% to 0.25% of GDP and from small businesses taxation (from 0.37% to 0.39% of GDP).

Таблица 20

**Tax Revenues in the Budgets of the RF Subjects
in 2005-2008 (% in GDP)**

	2005	2006	2007	2008
Tax revenues, including:	10.32	10.24	10.97	10.56
Corporate profit tax	4.42	4.32	4.64	4.22
Personal income tax	3.27	3.46	3.84	4.01
Excise tax on goods, sold in the RF territory	0.68	0.60	0.54	0.46
Aggregate income tax	0.33	0.36	0.37	0.39
Property tax, including	1.17	1.16	1.25	1.19
Business property tax	0.70	0.75	0.80	0.78
Royalty	0.25	0.25	0.23	0.25

Source: Federal Treasury, authors' estimates.

In 2008 the trend to a reduction in the inter-regional irregularity in the tax revenues of the RF Subjects on a per capita basis was sustained. The corresponding coefficient of variation value has significantly decreased from 96.7% in 2007 to 89.1% in 2008. It is worth noting, that in 2006-2008 there were no major changes in the allocation of revenue sources between government levels. Therefore, the reduction of irregularity in the distribution of tax revenues was based on the natural economic processes. This can be explained as follows.

First, the share of personal income tax in the tax revenue of the RF Subjects has significantly increased, that tax base (as opposed to corporate income tax base) is fairly evenly distributed across the regions. Second, the data obtained confirm the hypothesis put forward in previous surveys. Under this hypothesis, there are two factors in the reduction of the inter-regional differentiation across the major socio-economic indicators: rapid economic growth in the number of regions, that are currently getting considerable donations, and the migration of people from unpromising areas of the country to the rapidly developing economic centers. As a result of the interaction of those processes, the currently underdeveloped regions will either «catch up» with their economically developed neighbors, or will lose nearly all their population. In both cases, the variation coefficient of tax revenues per capita across the RF Subject should be reduced. And third, in the last months of 2008, the crisis in Russia was aggravating, which especially affected the most economically underdeveloped regions. As a result, tax revenues in economically developed Subjects, if not declined in nominal terms in 2008, have grown to a much lower level than could have been reached under the more favorable economic conditions. Apparently, this factor will be the determining one for the changes in inter-regional differentiation in 2009.

In real terms, tax revenues of the consolidated budgets of the RF Subjects have grown by 7%, significantly lower than the indicator of 2007 (17.4%). The maximum growth in tax revenues in the preceding year was recorded in 2008 in Chukotka Autonomous Okrug, the Republic of Dagestan and in Perm Region. At the same time, in six regions this type of reve-

nue has reduced in real terms¹. The maximum decline was recorded in the Republic of North Ossetia, Krasnoyarsk Krai and Murmansk Region. In 2008, two regions with the high budget level, Krasnoyarsk Region and Moscow have been enclosed in that group, which in 2007 demonstrated a substantial increase in tax revenues, and Moscow has been a leader in that indicator.

In the majority of regions, the decline in revenues is largely based on the decrease in payments of corporate income tax. Thus, the corporate income tax revenues have fallen in real terms in the Krasnoyarsk Krai by 21.1%, in the Murmansk Region by 24.5%, in Moscow by 14.7%. Herewith, in Krasnoyarsk Region and in Moscow the share of corporate income tax in the tax revenues of the consolidated budget of the Subject has significantly exceeded the average countrywide level (42.3%) and amounted to 56.6% and 61.3% accordingly.

In 2008, for the first time since 2003, there was recorded a cumulative deficit of consolidated budgets of the Federation Subjects, which amounted to 0.13% of GDP. This deficit resulted from faster growth in expenditures, as compared with an increase in income as a percentage of GDP. Therefore, at the level of regions, the trend of recent years to increase public expenditures at a rapid pace was sustained. It is also important to note that if in 2007 the number of the regions with the budget surplus has exceeded the number of regions with the budget deficit (48 and 36, respectively), whereas in 2008, the situation was different: 45 regions have completed the fiscal year with a deficit and only 39 with a surplus (see *Table 21*). Herewith, the Subjects with a high budget level, such as Moscow and St. Petersburg had the largest budget surplus in 2007, whereas in 2008, by contrast, they have been the leaders in terms of the deficit volume.

It should be noted, that the above annual dynamics of the major indicators in the regional budgets revenue sources do not fully reflect the situation at the end of 2008. To make more adequate assessment of the impact of economic crisis on the formation of budgets of the RF Subjects, it is necessary to review the changes of the last months of the year in more detail.

Table 21

Russian Regions Grouped as per Budget Deficit/Surplus

	2007		2008	
	No of regions	RUR, bln	No of regions	RUR, bln
Deficit of the RF consolidated budget	36	87.6	45	135.4
Surplus of the RF consolidated budget	48	126.0	39	80.9

Source: Federal Treasury, IET estimates.

Since November 2008, the economic crisis began to significantly affect the revenues of regional budgets. Initially, the reduction of revenue has especially affected economically developed Subjects of the Russian Federation (Tyumen Oblast, Orenburg Oblast, Khanty-Mansiysk, Chelyabinsk Region, etc.), whose revenue is largely dependent on the financial standing of the large taxpayers, engaged in the metallurgical, oil, chemical and other industries (see *Table 4*). In November-December 2008, tax revenues of the consolidated budget of the Russian Federation have declined in nominal terms in 34 regions, as compared with the level of 2007. Herewith, a significant decline (over 10%) was observed in 14 regions.

¹ Moscow, Krasnoyarsk, Murmansk region, Republic of North Ossetia, Kamchatka Krai and the Republic of Kalmykia.

Table 22

**Regions, which Revenues Have Especially Decreased as a Result
of the Economic Crisis at the End of 2008**

Region	Tax revenues decline in nominal terms in November-December 2008 in% against November-December 2007
Tyumen Region	-33.1
Orenburg Region	-25.5
Khanty-Mansiysk Autonomous Region	-23.6
Chelyabinsk Region	-22.0
Republic of Sakha (Yakutia)	-21.9
Vologda Region	-21.4
St. Petersburg	-20.8
Republic of Tatarstan	-20.1
Belgorod Region	-17.3
Ulyanovsk Region	-15.4
Sverdlovsk Region	-15.3
Murmansk Region	-14.6
Krasnoyarsk Region	-11.5
Udmurt Republic	-10.0

Source: Federal Treasury, IET estimates.

However, it can be assumed that as the economic crisis is expanding, its negative impact on sub-national budgets will involve more and more regions, with both, high and low economic development levels.

As in the analysis of annual trends, the above reduction in tax revenues was primarily based on the reduced revenue from corporate income tax proceeds, started at the end of the year. In November-December 2008, corporate income tax proceeds in the consolidated budget of the Russian Federation Subjects in nominal terms have decreased by 30.5%, as compared with the relevant period in 2007. the Downfall in revenues has affected virtually all Subjects of the Federation (65 regions).

Summarizing the analysis of revenues of regional budgets, it can be concluded, that the crisis provoked a substantial reduction in revenues of nearly all the Subjects of the Russian Federation. In some regions, receiving a permanent financial support from the federal budget, the situation is better. However, their situation is directly dependent on the sustainability of federal finances. It can be assumed that the execution of the Federal Subjects budget revenue will remain quite tense in January-April of 2009, until the refund of the over-paid corporate income tax in 2008. At the end of 2008, there aroused grounds for the softening of the RF Subjects revenues in the medium term. We are speaking of, first of all, of the «smooth devaluation», which is likely to positively affect the profits of exporting businesses. The weakening ruble rate and the end of the period of return of the overpaid corporate income tax will result in the stabilization of regional income, starting from May 2009. Moreover, in the absence of significant improvement of external economic conditions and a suspension of the crisis deepening in the economy, the proceeds of the Russian Federation will be substantially lower than the income in 2008 and within 2009-2010. Therefore, the majority of the Subjects of the Russian Federation will need to review their expenditure liabilities on the basis of the amended income.

Let us consider now the quantitative parameters of financial assistance to the regional budgets from the federal budget in 2008. As one can see from the presented in Table 5 data, in 2002-2006 there was observed a trend to a gradual reduction of the amount of federal financial resources, allocated to subnational budgets (from 3.03% to 2.17% of GDP). In 2007, this trend was suspended and the amount of intergovernmental transfers increased to 2.57% of GDP. In 2008, the growth in the share of funds, allocated from the federal budget for financial assistance to the regions was continued, and this indicator accounted to 2.64% of GDP.

A more detailed analysis of the structure of intergovernmental transfers allows to note the following. In 2008, donations to Regions for the adjustment of budget insufficiency from the Fund of Financial Support to the Regions (FFSR) in terms of GDP share remained at the level of 2007 (0.79% of GDP). Therefore, in 2007-2008 downgrading of FFSR volume as a share of GDP, observed in the period from 2002 to 2006 has stopped. Naturally, this fact should be assessed as positive. It seems that among all types of intergovernmental transfers, the FFSR should be given priority, as the allocation of its funds is performed in accordance with the relatively transparent procedures. Herewith, it should be noted, that the share of donations for the adjustment of the budgetary sufficiency in the total volume of transfers in 2008 has remained virtually unchanged as compared with 2007 and amounted to about 30%.

By the RF Government Decree № 593, dated August 12, 2008, some amendments have been introduced to the new method of donations distribution from the Fund for Financial Support to the Regions², which have entered into force on January 1, 2008. It is worth reminding, that as a result of the new way of tax estimates procedure, introduced in 2008, fiscal capacity of many regions has undergone significant changes. To avoid abrupt negative variations in the amount of subsidies, allocated for the Subjects of the Russian Federation, the new method of grants distribution from FFSR provided for a mechanism of compensation. The scope of compensation to the region for losses during the transfer to the new method depends on the regions performance indicators in terms of arrears redemption and an increase in revenue to the budget of the Russian Federation Subject (this is one of three requirements, set forth in the new methodology for the distribution of donations from the FFSR). It was proposed to allocate the donations for partial compensation to the Russian Federation Subjects for the reduced donations for their budget sufficiency adjustment as the level of 2007, basing on bringing the level of subsidies up to 100% in 2008 (95% in 2009, 90% in 2010, to 50% in 2011 and further years) on condition of performance of 2 or 3 requirements, to 90% (80% in 2009, 75% in 2010, in 2011 and subsequent years), on condition of performance one requirement and up to 85% (75% in 2009, 70% in 2010, 30% in 2011 and subsequent years) in case of failure to fulfill any requirements.

Amendments to the methodology, made in August 2008, first, have limited term of the said compensation mechanism (only through 2011), and second, have reduced the adjustment coefficients for 2009-2010. Since 2009, the amount of compensation is estimated on the basis of bringing the level of donations (as compared with 2007) to 90% in 2009 (80% in 2010 and 50% in 2011) under condition of performance of 2 or 3 requirements, up to 75% (to 60% in 2010, to 40% in 2011), under condition of fulfilling one requirement and to 70% (to 55% in 2010, to 30% in 2011) in case of failure to fulfill any requirements.

² For details of the donations allocation from FFSR, effective from 2008, see the “Russian economy in 2007: Trends and Prospects”. Moscow, IET, 2008. PP. 164-167.

In 2008 the trend of recent years to increase funding from the **Compensation Fund** was sustained. The total amount of subventions from this fund has been increased against 2007 from 0.43% to 0.51% of GDP³. This trend is due to the distribution of authorities across the levels of the budgetary system and the tendency of the federal government to fund the federal challenges in full scope.

After an upsurge of the **Fund for Co-financing of Social Expenditure** growth from 0.04% of GDP in 2004 to 0.12% of GDP in 2005, urged by «benefits monetization» (a large share in the Fund expenditures made the subsidies for partial reimbursement of measures of social support to the veterans and other special categories of citizens), there occurred a gradual decline in this type of transfers in 2006-2008. In 2008, the share of subsidies for co-financing of social expenditures⁴ in GDP fell down by 0.01 p.p. as compared with 2007 and accounted to 0,09% of GDP. The amount of subsidies, allocated from the federal budget for the reform of regional and municipal finances has been unchanged and amounted to about 0.01% of GDP. The share of subsidies to regional budgets for the development of social and engineering infrastructure of the Russian Federation Subjects and municipalities⁵ remained at the level of 2007 and amounted to 0,02% of GDP.

Reduction of the share of donations for the measures to maintain the regional budgets sufficiency from 0.17% to 0.11% of GDP in 2008 should be regarded as a positive trend. Active usage of this funding mechanism aggravates the problem of «soft budget constraints». At the same time, a positive factor is the total rejection of such tool in the practice of intergovernmental fiscal relations as the transfer of funds under the terms of mutual-settlements. That tool in the inter-budgetary relations is one of the least transparent.

Reviewing the issues of financial relationship between the federal center and regions, one cannot fail to note the emergence of the new type of transfers in the Budget Code in 2008. The issue under review is the Article 138.1 of the RF Budget Code⁶, defining the concept of the federal budget subsidies from the budgets of the Russian Federation Subjects. This type of subsidy is defined as an intergovernmental transfer, addressed to the federal budget from the budget of the Russian Federation Subject for co-financing of expenditure obligations of the Russian Federation, emerging from performance of liabilities of the state authorities of the Russian Federation in cases, stipulated by federal laws.

Objectives and conditions for granting and disbursing these subsidies are set forth by agreements between the federal executive authority and the relevant supreme executive authority of the Russian Federation Subject⁷. The Ministry of Finance of Russia has stressed, that granting of such subsidies is the right, rather than the responsibility of regional authorities. The emergence of this type of transfer in the Budget Code should not be regarded as an

³ For the purposes of this survey (to ensure comparability of the data), the amount of funding from the Compensation Fund for 2008 includes not only the subventions, but also a number of intergovernmental transfers that, included in that Fund in 2007.

⁴ Before 2008, those subsidies have been merged into the Fund of social expenditures co-financing, since 2008, this Fund was not allocated.

⁵ Before 2008, those subsidies have been merged into the Fund financing for Regions development.

⁶ Introduced by the Federal Law № 141-FZ, dated July 22, 2008 «On Amending Certain Legislative Acts of the Russian Federation to improve land relations».

⁷ Regulations on conclusion of such agreements are approved by the Government Order of the Russian Federation № 752 of October 13, 2008 «On approval of agreements provisions between the federal executive and the supreme executive authority of the state power of the Russian Federation to grant the federal budget funds from the budget of the Russian Federation».

attempt of «negative transfer» application at the federal level. It should be emphasized, that neither the provisions, stipulated in Article 138.1 of the RF Budget Code, nor the rules of the appropriate agreements between the Federal Center and regions, approved by the RF Government do not provide grounds for an analogy between this kind of subsidies and «negative transfers», applied at the regional level. These subsidies serve as a mechanism for increasing flexibility of the existing allocation of authority.

Since 2004, the attempts were made to increase the transparency of inter-budgetary relations. Currently, the Fund of Financial Support to the Regions and the Fund of Grants, allocated for the reform of regional and municipal finance, as well as the development of social and logistics infrastructure are allocated under the methodology, approved by the RF Government. Under the formalized method, the subsidies are estimated for social expenditures. Nevertheless, the share of intergovernmental transfers, distributed on a formalized basis, in 2008 amounted to only about 60% of the total amount of funds, transferred to the federal subjects of Russia. It should be noted, that this indicator is based on an analysis of the distribution methods of transfers from public sources⁸. Therefore, the assessment does not mean that the balance of the federal financial assistance to regions is allocated regardless methodological and financial feasibility studies. Thus, according to the Ministry of Russia estimates, over 95% of intergovernmental transfers are allocated on the basis of uniform methodologies, based on objective indicators, determining the need for financing. However, the methodological approaches to the allocation of transfers, provided in such cases, have not been stipulated in the open-access legal regulations.

In 2008, there continued the practice of revising the Law on the Federal Budget and Increasing the Estimated Amounts of Financial Assistance to Regions. The amount of additional (not foreseen at the beginning of the fiscal year) aid amounted to about RUR 168 billion. In GDP percentage, the amount of additional assistance in 2008 has grown twice as compared to 2007 - up to 0.4% of GDP. It should be noted, that a significant increase of the transfers could be linked to the need for adjustment due to changes in the key macroeconomic indicators adjustments. The first version of the Law «On the Federal Budget for 2008 and for the forecast for 2009 and 2010» was adopted back in July 24, 2007, and it laid the parameters (especially for GDP and inflation rate), later subjected to a significant adjustments. At the same time, it should be emphasized, that if amendments were made in regard to the macroeconomic forecast, the FFSR volume should have been amended, but it remained unchanged.

Examples of additional financial assistance are as follows:

- 1) donations for the balance of regional budgets have been increased during 2008 from RUR 31 billion to RUR 46 billion, i.e., by 48%;
- 2) subsidies to agricultural producers to recover the cost of interest on loans have been increased from RUR 27 billion to RUR 34 billion, i.e., by 25%;
- 3) subsidies to the Subjects of the Russian Federation for the land plots communal infrastructure support for the purpose of housing construction have been increased from RUR 5.9 billion to RUR 7.8 billion, i.e, by 33%;
- 4) subsidies to the Russian Federation Subjects for the measures to provide housing facilities to the categories of citizens on the basis of the decisions of the Government of the Russian Federation have been increased from RUR 328 million up to RUR 1.7 billion, i.e., by 509%.

⁸ «Consultant Plus» legal data base and official web-sites of Ministries and Government agencies.

Totally, the subsidies for the balance and additional funds under other financial assistance channels have amounted to about 18% of total inter-budgetary transfers from the federal budget, allocated to the regions in 2008. Such a large share of those two tools, that contribute to the effects of the «soft budget constraints» sources of the regional authorities is an important shortcoming of the currently effective distribution of financial assistance to regions.

Table 23

**Financial Assistance, Provided to Consolidated Budgets of the RF Subjects
from the Federal Budget in 1992–2008 (% of GDP)**

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
1. Financial assistance to the budget of other levels				1.8	2.3	2.5	1.6	1.18	1.43	1.79	2.2	1.94	1.7	1.65	1.52	1.79	1.89
1.1. The federal targeted programs, as well as subsidies to the RF Subjects for the support of agriculture, water management, small business and rehabilitation of children														0.05	0.15	0.39	0.54
1.2. Social expenditures financing											0.15	0.11	0.04	0.12	0.11	0.10	0.09
1.3. Fund for Financial Support to the Regions:	0	0	0.36	1.17	1.04	1.22	1.12	0.99	0.96	1.14	1.36	1.3	1.05	0.88	0.94	0.79	0.79
donations for adjustment of regional budget sufficiency	0	0	0.36	0.86	0.68	0.86	1	0.99	0.96	1.14	1.36	1.3	1.05	0.88	0.94	0.79	0.79
government support to the “Northern delivery” transfers at the expense of VAT	0	0	0	0.31	0.36	0.36	0.12	-	-	-	-	-	-	-	-	-	-
1.4. Donations and subventions, including:	0	0.02	0.09	0.06	0.09	0.13	0.1	0.06	0.15	0.54	0.28	0.29	0.27	0.36	0.21	0.31	0.22
donations for measures for adjustment of regional budget sufficiency													0.11	0.24	0.16	0.17	0.11
1.5. Assets of the Fund for regional finance reform										0	0.01	0.01	0.01	0	0.01	0.01	0.01
1.6. Other grants and non-recoverable transfers (subsidies and subventions)											0.01	0.01	0.01	0.01	0.08	0.17	0.19
1.7. Fund for financing Regions development									0.03	0.05	0.1	0.1	0.15	0.01	0.01	0.02	0.02
1.8. Funds, transferred under mutual settlements	0.61	1.95	2.54	0.42	0.81	0.43	0.36	0.14	0.28	0.05	0.2	0.14	0.12	0.01	0.05	0.02	-
1.9. Loans and budget credits less	0.09	0.03	0.02	0.04	0.23	0.64	-0.03	-0.1	-0.08	0.02	0.09	-0.01	-0.02	-0.03	-0.04	-0.01	0.03

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
redemption of other levels of government management*																	
2. Compensation Fund										0.37	0.38	0.36	0.34	0.17	0.30	0.43	0.51
3. Other Intergovernmental transfers, including: Public support to road facilities**								0.18	0.11	0.4	0.45	0.54	0.35	0.33	0.34	0.36	0.27
Total funds, transferred to the budgets of other government levels	1.49	2.7	3.4	1.8	2.3	2.5	1.6	1.36	1.54	2.56	3.03	2.84	2.39	2.25	2.17	2.57	2.67

*Since 2005 – only budget credits.

**Currently the bulk of transfers for the support of road facilities is included in 1.1.

Source: Federal Treasury, IET estimates.

2.3.2. Measures, taken by the RF government to mitigate crisis impacts to the Regions

Trends observed in the sub-national finances in the last two months of past year, confirm the crisis expansion in the region's economy and, consequently, increase the tension in the area of regional finance. In view of these circumstances, the Ministry of Finance and the Government of Russia in late 2008 and early 2009 took a series of measures aimed at mitigating the impact of the crisis on the sub-national budgets.

On December 20, 2008, a letter⁹ was sent by the Ministry of Finance of the Russian Federation to all the RF Subjects with explanations of the priority measures to be taken by the Subjects in 2009 with the aim of preventing crisis in the financing of expenditure liabilities of regional authorities. In general, the recommendation of the Ministry of Finance were addressed primarily to the most conservative expenditure estimates for 2009 with regard to the reduction in estimates for the tax bases growth (first, corporate profits and payroll fund). Herewith, it was highlighted, that expenditures sequestering, when the budget is under execution is undesirable.

It should be noted that in the above-mentioned letter states, that «The Ministry of Economic Development of the Russian Federation is developing an updated forecast of the socio-economic development of Russia for 2009-2011». Herewith, that forecast has not been approved neither at the end 2008, nor in the early 2009. Therefore, it is still unclear, on what basis the Regions should adjust their budget estimates. In our view, the Subjects of the Russian Federation, should have clear understanding, that the federal center expects them to take active measures to adapt to the new trends in economic development, including the development of regional socio-economic development estimates, based on local situation. This is primarily based on the fact, the macro-economic indicators, estimated at the federal level, in the period of high volatility in economic conditions can differ from the actual socio-economic development in specific regions. As a result, the awareness of regional authorities on the sta-

⁹ Letter of the Ministry of Finance of Russia № 06-03-07, dated of 20.10.2008 «On recommendations on the formation of budgets of the Subjects of the Russian Federation in 2009 and for the planed period up to 2010 and 2011 years».

tus of the largest taxpayers in the area can provide more adequate information for the budget indicators, than federal estimates.

The letter was also provided a number of specific recommendations to the Subjects of the Russian Federation. First, the need to address the surplus revenues, received in 2008, a reserve fund for 2009, rather than to finance expenditures of the current year (as it used to be done in all preceding years). Second, it was emphasized, that the decision to raise the salaries of the public sector employees should be implemented with due regard the capacity of regional budgets. Herewith, the salaries rate upgrading of the federal agencies offices should not be taken as a benchmark for similar solutions at the regional level. And third, the letter noted that the volume of the RF Subjects budgets deficits should be planned with regard to the available credit resources and opportunities for the debt securities placements.

Let us review the actual situation with the prospects for the formation of the financial reserves of the regional budgets. According to the RF Ministry of Regional Development, the untargeted balances, carried over to 2009, not addressed to cover the budget deficit in 2009, amounted to about RUR 273 billion. The largest balances are available in seven Subjects of the Russian Federation; their share exceeds 10% of the revenues, estimated for 2009 in the following regions: Lipetsk, Tver, Tyumen, Chelyabinsk, Sakhalin Region, Yamalo-Nenets and Chukotka Autonomous Region. Those regions have great potential to compensate for decreased revenues in 2009. However, the majority of Regions have no significant balances, carried over to 2009 and will be forced to significantly reduce their expenditures in the first quarter of 2009.

There are three main reasons for the fact that at the end of 2008, despite the recommendations of the Ministry of Finance of Russia, in the majority of the Russian Federation Subjects were unable to accumulate significant financial reserves (see *Table 24*):

- objective slowdown in revenue growth of consolidated budget of the Russian Federation Subjects at the end of 2008. In November-December 2008, the total income of the Subjects of the Russian Federation has grown only by 5.7% against the same period in 2007. It is obvious, that at the beginning of fiscal year many Subjects of the Russian Federation hoped for greater revenue growth in 2008. Consequently, the majority of the RF Subjects have not obtained considerable surplus revenue as compared to the estimates of the late 2008;

- inertia of the budget process. The Subjects of the Russian Federation failed to dismiss many expenditure liabilities on time;

- intentional reluctance of regional authorities to reduce expenses and accumulate financial reserves. In the situation, when the federal center has not provided a clear macroeconomic forecast for 2009, as well as the criteria for provision the financial assistance to regions, some regions have intentionally refused significantly to cut down in late 2008 and, accordingly, have failed to form necessary financial reserves. In some regions this was done out due to the doubts, that the federal center will provide emergency financial assistance only to those Subjects of the Russian Federation, who have a cash gap (i.e., no financial reserves).

Table 24

Russian Regions, Grouped with Regard to Budget Balances of 2008 versus 2007

	Number of Regions	Total balance at the end of the year, RUR, bln
Balance increased	36	33
Balance reduced	58	101

As a result, if at the federal level the expenditures can be maintained in the volume of 2008 for 1-1,5 years at the expense of by the Reserve Fund, the majority of the regions will not have such opportunity even in a the first quarter of 2009. The majority of regions in 2008 failed extend their reserves (balances), but have reduced them as compared with 2007. The most notable exceptions to this rule were Tyumen Region (balance in 2008 was extended by 9%), Perm Region and Chelyabinsk Region (growth by 6%).

At the end of 2008 amendments were made to a number of articles of the Tax and Budget Codes, related to revenue sources of regional budgets. First, amendments were made to the Art. 284 on the Tax Code¹⁰, regulating the corporate tax rate. The total rate is reduced from 24% to 20% since January 1, 2009. Herewith, the reduction is carried out exclusively at the expense of the federal budget. Moreover, 0.5% of the tax rate has been transferred to the budgets of the Russian Federation Subjects. Therefore, the amount of tax, assessed at the tax rate of 2%, is transferred to the federal budget (6.5% earlier), and the tax amount, assessed at the tax rate of 18% is addressed to the regional budgets (17.5% earlier). Herewith, the bottom threshold for the regional tax rate has remained unchanged - 13.5%, which has resulted in an upgrading the maximum level regional benefit for the tax on profit from 4% to 4.5%. A number of amendments were made to the Budget Code¹¹ as well. In particular, amendments were introduced to Art. 56, defining the tax revenues of the budgets of the Russian Federation Subjects. From January 1, 2009, revenues from excise taxes on motor gasoline, straight gasoline, diesel fuel, motor oil for diesel and carburetor (injector) motors shall be transferred to the regional budgets at the rate of 100% (60% earlier).

Also, the changes have affected part of the legal acts, relating the budget credits (Articles 93.2 and 93.3 the RF Budget Code). First, the terms, for which the budget credits are provided, is expended from one to three years. Second, the Subjects of the Russian Federation, located in the areas of the Far North and similar territories, where the term of cargo delivery is limited, up to January 1, 2011 are granted the right to provide budget credits (at the expense of regional budgets) to legal entities for the purchase and delivery of fuel to those Subjects. Earlier, the right to provide budget credits to legal entities (including foreign legal entities), was only in the authority of the Russian Federation, and even then only at the expense of targeted foreign credits (borrowings), even in the case of liabilities (debts) restructuring of legal entities for the earlier credits, provided form the budget and in cases, stipulated by Chapter 15 of the RF Budget Code («RF External Debt Claims»). In addition to amendments in the number of articles of the RF Budget Code, related to budget credits, it is planned to amend the rate on the total amount of budget credits from the federal budget in 2009. In the adopted Law «On the Federal Budget for 2009 and planning period 2010-2011» this rate is set at RUR 20 billion. The Ministry of Finance of the Russian Federation plans to increase this rate at least at RUR 100 billion. This indicator is assessed, basing on the fact that in 2008, according to the Ministry of Finance of Russia, regional budgets have attracted about RUR 150 billion of commercial credits. Herewith, the Ministry is pursuing the objective to partially compensate a significant reduction in the capacity of regions to attract credit resources in

¹⁰ Federal law № 305-FZ of December 30, 2008 «On amendments to Article 284 of Part Two of the Tax Code of the Russian Federation».

¹¹ Federal law № 310-FZ of December 30, 2008 «On Amendments to the RF Budget Code and the Federal Law «On Amendments to the Budget Code in terms of the budget process management and bringing legislative acts of Russia in line with the budget legislation of the Russian Federation».

2009. In the future, apparently, the limit on the total amount of budget credits will be further upgraded.

On December 31, 2008 the Resolution of the RF Government N 1089 «On subsidies from the federal budget to the budgets of the Russian Federation Subjects for implementation of additional measures, aimed at reducing tension in the labor markets of the RF Subjects». It is planned to allocate RUR 43.7 billion from federal budget for such subsidies in 2009.

Subsidies are provided for co-financing regional programs on implementation of the following additional measures on reducing the tension in the labor market of the RF Subjects:

a) advanced vocational training for employees in the event of a threat of mass dismissals (establishment of a part-time working day, temporary suspension of works, leaves without pay, arrangements for the release of employees);

b) public works, temporary employment, internships to gain experience for the unemployed citizens, job seekers, including graduates of educational institutions, as well as workers in the event of a threat of mass dismissals;

c) targeted support to citizens, including arrangement of their moving to another location of their new jobs, created in the framework of federal targeted programs and investment projects;

d) assistance to small business and self-employment development.

It should be noted that the allocation of subsidies on the fourth measure is partially duplicating another federal program on co-financing regional programs for the support of small and medium-sized businesses for which it is supposed to allocate RUR 10 billion from the federal budget.

The subsidy assessment is implemented on each of the four above measures in accordance with the formula, provided in the regulations on this type of subsidies.

It should be noted that along with the standard requirements (such as reasonable grounds for implementation of relevant measures, a list of beneficiaries, etc.), the regional program should include measures, aimed at reducing the number of foreign employees.

Review of regional programs is implemented by the Ministry of Health and Social Development of the Russian Federation with the participation of interested federal executive authorities. The Ministry of Health and Social Development of Russia within 10 days from the date of receipt of the regional program should develop an expert opinion and submit it to the Government of the Russian Federation. Selection of regional programs for subsidies allocation is implemented by the interdepartmental working group on monitoring the situation in the labor market.

The criteria for selection of the Russian Federation Subjects subsidies allocation are:

a) growth of unemployment level in the Russian Federation Subject;

b) increasing number of employees of the Russian Federation Subject under the threat of mass dismissals (or establishment of part-time, temporary suspension of works, provision of leaves without pay, arrangements for the release of employees);

c) presence or core businesses in the Subject of the Russian Federation.

Subsidies are provided in accordance with the decision of the interdepartmental working group on the basis of agreements, concluded by the Federal Service for Labor and Employment with the government authorities of the Russian Federation Subjects. The scope of co-financing of regional programs, aimed at reducing tension in the labor market, is set up at 95% to be allocated from the federal budget.

2.3.3. Federal budget draft for 2009 and until 2011 for the allocation of intergovernmental transfers to other levels of the budgetary system

The total amount of funds, planned to be transferred to the regional and local budgets in 2009 is about RUR 1228 billion. This is 1.12 times more than the funds actually allocated for this purpose from the federal budget in 2008. Herewith, the total expenditures of the federal budget will grow 1.19 times. As a result of slower growth of intergovernmental transfers to other levels of the budgetary system, their share in the federal budget expenditures will decrease as compared with 2008: from 14.5% to 13.6%. Given that in the late 1990-s only the share of donations from the Fund for Financial Support to the Regions was 14% of the federal budget, and the major revenue sources are currently concentrated in the federal budget, the reduction of the share of intergovernmental transfers, allocated to other levels of the budgetary system in the federal budget is challengeable.

It should also be noted, that the system of intergovernmental transfers is becoming increasingly complex and confusing. In developed countries with a federal form of government, as a rule, there are 1-3 major transfers from federal funds to the budgets of territories and 3-15 smaller transfers. In the Russian Federation, according to the draft budget for 2009 and until 2011 there are over 130 different transfers (6 donations, 90 sub-grants, including federal targeted programs and sub-programs and 16 related to the category of other intergovernmental transfers). The question arises, whether such a system is effective. By analogy with taxation, the number of transfers should be acceptable for the effective administration. Under 58 objectives, the funding is less than RUR 1 billion. This means that for an individual Subject of the Russian Federation the funding for several objectives can amount to tens or hundreds thousands rubles. It is obvious that with the targeted nature of the majority of subsidies (grants and subventions), expenses to assess the targeted utilization of those assets, not to mention the assessment of the effectiveness, can exceed the benefits from the allocated funds.

In our view, it is necessary to thoroughly review the allocation of powers between the federal center and regions, in order to delegate a number of powers to the regions, but some powers should be returned to the federal level. It should be noted, that the recently the revision powers delegation among the levels of budget system occurs nearly every year, what reduces the predictability of the basic parameters of the budgetary system for the regional and local authorities and adversely affects the quality of the state and municipal finances management.

In this regard, it would be inexpedient to make significant changes in the delegation of authorities on fiscal management during the three years of 2009-2011. This period should be used for monitoring and assessment of the existing system efficiency.

Starting from 2012, an opportunity should be provided to review the current system powers delegation in order to reduce the scope of authority, as well as to delegate to each level of government those powers, which can be most effectively accomplished by this level of power.

An additional way to address the problem of the large number of insignificant in volume targeted intergovernmental transfers, and to improve management of the allocated financial resources is their incorporation in block transfers. The main point of block transfers is that the financial resources, provided within a single intergovernmental transfer can be used in many ways. Herewith, the level of government, from which budget the block transfers is allocated, can establish the terms for distribution of those transfers, as well as the objectives

of their disbursement. The level of authority, that receives a transfer block, can independently choose the scope of funds to be addressed to each objective.

This will improve the quality of public and municipal finance management with the best regard of local population preferences and national priorities. After 2010, it seems appropriate gradually to replace the majority of disparate regional subsidies by the intergovernmental block transfers. In view of a high degree of differentiation of the tax capacity and the cost of budgetary services to the regions of the Russian Federation, it looks appropriate to allocate block transfers from the federal level with regard to the regions' budget sufficiency. However, the scope of financing regional budgets adjustment should be lower the funding, allocated from the Fund for Financial Support to the Regions. It is proposed to allocate block transfers in proportion to the regional budgets deficiency against the fiscal sustainability of the richest region.

In the medium term, it seems appropriate to achieve the unification of subsidies preferably in one inter-industry block of transfers in order to ensure a real, rather than a declared independence of the regions in those assets management to achieve socially meaningful results. Industry-addressed subsidies do not provide such opportunities, further strengthening the authority of federal ministries over the region. An inter-industry approach is required, whereas:

- the volumes of the subsidies to the regions should be assessed by a uniform methodology that takes into account the budgetary sufficiency;
- each federal branch ministry within their competence should develop the terms for spending the assets according to their objectives;
- regional authorities should be given the right to choose independently the area (the industry), to which the funds will be spent.

The major channels of financial assistance to regional authorities are to the donations for the assistance for budget sufficiency adjustment from the **Fund for Financial Support to the Regions**, which will to grow by 13.8% (as compared with 2008) and reach RUR 374 billion. It should be noted, that in the initial budget estimates for the fiscal years of 2009-2011 an attempt was made to overcome the decline trend in the share of the fund in the intergovernmental budget transfers: according to the draft law on the federal budget for 2009 and until 2011, the FFSR share in the intergovernmental transfers to other levels of the budget system will grow to 30.0% in 2008, to 30.4% in 2009, to 32.8% in 2010 and to 35.3% in 2011. However, it should be noted that the initial draft budget is significantly different from its final execution. Branch ministries, as a rule, are able to lobby increasing subsidies and other intergovernmental transfers, while FFSR, estimated by the formula remains unchanged during the fiscal year. As a result, we put the trend, observed in the draft federal budget to increase the role of this channel of intergovernmental transfers, under doubt. There is a particularly high risk of reducing the role of FFSR in intergovernmental transfers during the financial crisis. Thus, the draft federal budget for 2008-2010 also provided for the FFSR growing share in intergovernmental transfers from 33.6% in 2007 to 35.6% in 2008, to 38.8% in 2009 and to 42.7% in 2010. However, due to the unplanned growth of subsidies volume there was no growth in the FFSR share, mentioned above, in 2007-2008. It seems that among all types of intergovernmental transfers, in the long run, the FFPR in particular should be given priority, as the organization of that fund is in line with the best international practice, and allocation of funds is carried out in accordance with the relatively transparent procedures. This conclusion can be slightly adjusted, since in the situation of the economic crisis there can be required to

provide emergency assistance to the Subjects of the Russian Federation. However, the economic crisis should not serve as an incentive for inconsiderate changes in the most transparent and effective budget management tools.

It should also be noted that there is a barrier in achieving the primary objective of the allocation of grants from FFSR (to provide all regions relatively equal opportunity for fiscal services); it is an attempt to achieve other goals, initially not foreseen for the Fund: to improve financial discipline in the regional authorities, to avoid sharp volatility in the volume of subsidies, to encourage regional governments to accumulate their own tax potential. For all the importance of these secondary objectives, an attempt to address them all together with a single financial instrument can result a failure to reach any of those tasks.

Since 2005, the assets for financing all federal spending, set out in explicit legal form are accumulated in the **Compensation Fund** (hereafter CF). The draft federal budget for 2009 and until 2011 provides some stability in the FC share in the intergovernmental transfers to other levels of the budget system (18-20%). It should be noted that the share of subventions in the intergovernmental transfers to other levels of the budget system is still high. On the one hand, the desire of the federal government to finance their expenditure objectives is an absolute advantage of the budget system in general. On the other hand, in the medium term, it is appropriate to verify the effectiveness of the existing delegation of authority and, if necessary:

a) to abandon delegation to the regions a number of federal powers by their funding transfer directly from the federal budget;

b) transfer a number of federal authority to the Federal Subjects in full scope with the corresponding increase of the non-targeted transfers and flexible terms of expenditure of funds received and/or expansion of revenues of regional budgets. For example, to transfer to the regions the authority to pay for housing and communal services to certain categories of citizens. Herewith, at the federal level, it is reasonable to take appropriate measures of social support to those categories of citizens in the form of increased pensions and social benefits, as well as increase funding from the Fund of Financial Support to the Regions. This will help to continue «monetization of benefits» in line with the social support, provided to those categories of citizens at the federal level and in creating opportunities for all regions for further support to those beneficiaries by increasing subsidies from FFSR.

c) consider delegation/centralization of some powers on a contractual basis, with clear, legally stipulated terms of such contracts. It is worth noting, that Russia has a substantial negative experience in terms of authorities delegation on a contract basis, though international experience often witnesses in favor of the effectiveness of this mechanism. Therefore, return to this issue can be useful in the long term and will require a thorough legal and economic development.

In terms of **subsidies**, a significant growth is planned in 2009 budget draft for 2009 and until 2011: the subsidies in 2009 will grow to 1.52-fold as compared with the planned in the federal budget draft for 2008 and for the period up to 2010 - up to RUR 482.3 billion. The basic areas of expenditure of these funds in 2009 are:

- federal targeted program «Modernization of transport system of Russia (2002-2010 years)» - 16,2% of total subsidies;
- subsidies for highways - 7.3% of the total amount of grants;
- to support agricultural production - 14,4% of the total amount of subsidies;
- subsidies to support agricultural production - 14,4% of the total amount of grants;
- social support – 7.2% of the total amount of subsidies.

Subsidies from the federal budget for road facilities and the Federal Target Program «Modernization of transport system of Russia (for 2002-2010)» have a high social value in order to maintain the unity of the national territorial and economic environment, the support of the population mobility. The commitments on the implementation of the major road projects are high enough and in many cases can not be financed solely by the regional (and local) budgets. In this context, it seems appropriate to maintain the existing mechanisms for the distribution of those subsidies, which in general conform to the requirements of such instruments.

Herewith, in view of the more effective planning and spending of these funds, at least two features of the allocation of subsidies for road facilities should be taken into account. First, it is necessary to strengthen matching of the projects objectives, funded from subsidies, with the general trends and priorities of regional development, federal and local roads in the region, as well as other mechanisms and the scope of allocated financial assistance (decision on the allocation of subsidies for the road facilities one should take into account the budget sufficiency and the scope of financial assistance, obtained by the region receives for other objectives). Second, it is necessary to tighten the project selection criteria in terms of social and economic efficiency in applications for subsidies with regard to the region co-financing opportunities.

With regard to subsidies for agricultural production, the situation is significantly different. Transfer to the regional level the authority in support of agricultural production has resulted in the situation, when the most active support is provided is not in the regions with the most favorable natural and climatic conditions, but in those, where the largest financial resources are required to implement such policy. The allocation of federal budget funds for agricultural production on the basis of co-financing can strengthen this trend, in particular, result in the support of the most financially strong regions in the «trade competition wars» for agricultural markets in the more financially weak regions. The effectiveness of such subsidies raises serious doubts. The solution of this issue is the centralization of the federal subsidies for the support of agricultural production, accompanied by minimization of regional expenditure for this objective. At the same time, the role of the Federation in co-financing of expenditures for social development of rural areas should be increased.

As to co-financing of social expenditures, some adjustments have to be made in this area. In particular, it is appropriate to gradually abandon the co-financing of social support to the Veterans of Labor, for example, through the transitional period of 5 years, upon which the co-financing in this field will be canceled. The title «Veterans of Labor» is continued to be provided in the Russian regions, though the criteria for its provision significantly differ from region to region. Thus, this aspect of social support is not objective and fair, so co-financing of such expenditures from the federal budget in the long term can not be considered appropriate. Herewith, to initiate the procedure of co-financing of social support to the Veterans of Labor rejection during the economic crisis seems socially dangerous. For example, social support to the rehabilitated persons and victims of political repressions, as well as Prodders of the Rear is advisable to be implemented from the federal level. Those categories of beneficiaries have emerged as a result of decisions, taken by the supreme leadership of the country, rather than regional or local authorities. Therefore, the provision of social assistance should be the power of the state authorities of the Russian Federation. However, under the existing authority allocation, social support for these categories of the population is within the competence of the Russian Federation, and in order to transfer those powers to the federal level,

amendments should be made to several federal laws¹². However, during the economic crisis, the revision of authorities delegation in social policy seem to be socially dangerous, as there is a high probability of difficulties in the administration of those powers. In this regard, in the period of economic instability a palliative solution could be the concentration of financial and administrative resources of the federal and regional authorities in carrying out social obligations to the public.

As a general approach, the appropriateness of the allocation of small amounts of co-financing for those or other regional powers looks doubtful. Obviously, the minor scopes of co-financing do not allow providing significant additional funding to the Federal Subjects. During the economic crisis, this fact is aggravated by the procedure of subsidies allocation. In many cases regional authorities should actually make the expenditures in advance, and then the federal center will compensate for a part (in most cases 50%) of such expenses. During the economic crisis, this approach should be changed¹³. The level of co-financing the subsidies on the part of the Subject of the Federation in the period of crisis should be extremely low. Herewith, funding allocation should be made in accordance with the consolidated budget estimates, rather than after the expenses are made (in fact, currently the subsidies are made as compensations for prior expenditures).

In conclusion, it should be noted, that the economic crisis not only sets up certain risks for the system of intergovernmental fiscal relations, but opens opportunities for enhancing its effectiveness as well. The main risks to the system of intergovernmental fiscal relations are: 1) increase the role of discretionary intergovernmental transfers, allocated in the non-formalized manner, which create disincentives for the fiscal discipline of regional powers, 2) improper amendment the most transparent and effective budgetary management tools to adapt them to the changed conditions, 3) replenishment of the losses of the Subjects of the Russian Federation budget revenues at the expense of reducing the revenue base of local budgets (through the redistribution of income sources and increased use of negative transfers). The main opportunity for improving the efficiency of intergovernmental fiscal relations is a significant reduction in the number of the subsidies areas, addressed from the federal budget to the budgets of the Russian Federation Subjects, accompanied with an increase of the volume of other subsidies and their concentration at the solution of 3-4 most important priorities of the regions. The probability of making such decisions is increasing under conditions of reducing federal budget revenues and necessity to finance prioritized objectives of regional budgets.

¹² Law of the Russian Soviet Federative Socialist Republic № 1107-1, dated April 26, 1991 «On the Rehabilitation of Repressed Peoples», Law of the Russian Federation № 1761-1, dated October 18, 1991 «On the Rehabilitation of the Victims of Political Repressions», federal law number 5-FZ of January 12, 1995 «On Veterans», № 184-FZ of October 6, 1999 «On the general principles of organization of legislative (representative) and executive bodies of state power of the Subjects of the Russian Federation».

¹³ Ref. A.G. Siluanov, Conference «Economy of Megapolises and Regions»
<http://www1.minfin.ru/ru/official/index.php?id4=6882>