Policy Brief

March 2000

Economic Survey of the Russian Federation, 2000

Summary

The economic crisis of 1998 has victimised a number of important areas of institutional development and increased social distress among much of the population. A responsible fiscal and monetary response to the crisis, bolstered by a strengthened current account, has helped to stabilise inflation and the exchange rate, although the low level of reserves, the demands of foreign debt service, and threats to the independence of the Central Bank speak for the continued fragility of the achieved level of stability. A restructuring of foreign debt is critical for consolidating trends in the fiscal sphere. While the quick onset of a recovery in GDP in the wake of the weaker rouble is encouraging, delays in structural reforms and low administered input prices raise concern about the quality and sustainability of this growth. The restructuring and regulation of the commercial banking sector continues to pose major challenges to the Central Bank and the Russian government. Throughout a decade of transition, problems in demonetisation and fiscal federalist relations, the particular focus of this *Survey*, have been important underlying structural obstacles to economic reform. Although some institutional reforms have provided a foundation for a market economy, delays in addressing these and other fundamental problems have impeded efficiency and increased the comparative vulnerability of the Russian economy to external shocks. The future stability and growth of the Russian economy will require the continuation of responsible macroeconomic policies, but depends first and foremost on progress in structural reform, including tax reform, effective institutions of bankruptcy, competition, more decisive and comprehensive measures to combat the process of demonetisation, defend the rule of law, and realise fundamental reform in fiscal federalist relations. ■

This Policy Brief presents the main findings of the 2000 OECD Regional Economic Assessment of the Russian Federation. The Economic and Development Review Committee, which is made up of the 29 Member countries and the European Commission, reviewed this Assessment. A draft prepared by the Economics Department was revised following the Committee's discussions, and issued under the responsibility of the Secretary-General.

Observer oecd

Why has Russian economic performance been so disappointing?

The recovery of the Russian economy from the major economic crisis of 1998 provides an important context for a re-examination of economic policies pursued throughout the decade of transition. While Russia has made some progress toward the creation of a market economy in the last decade, the record of economic performance has been disappointing. Progress in macroeconomic stabilisation since 1995, leading by 1997 to modest gains in output, living standards and financial market development, raised some hopes that the Russian economy had finally turned the corner in the direction of economic growth and social welfare. But these hopes soon faded in the context of the major financial crisis of 1998 and further economic decline. The crisis victimised a number of areas that had experienced the most impressive progress during 1994-97, including the credibility of monetary policy and the regulation of commercial banks and financial markets. Important initiatives for strengthening institutions of bankruptcy and corporate governance have suffered along with the virtual paralysis on domestic financial markets since mid-1998. The effect of the crisis was particularly severe for emerging entrepreneurship, which is concentrated in services and import trade.

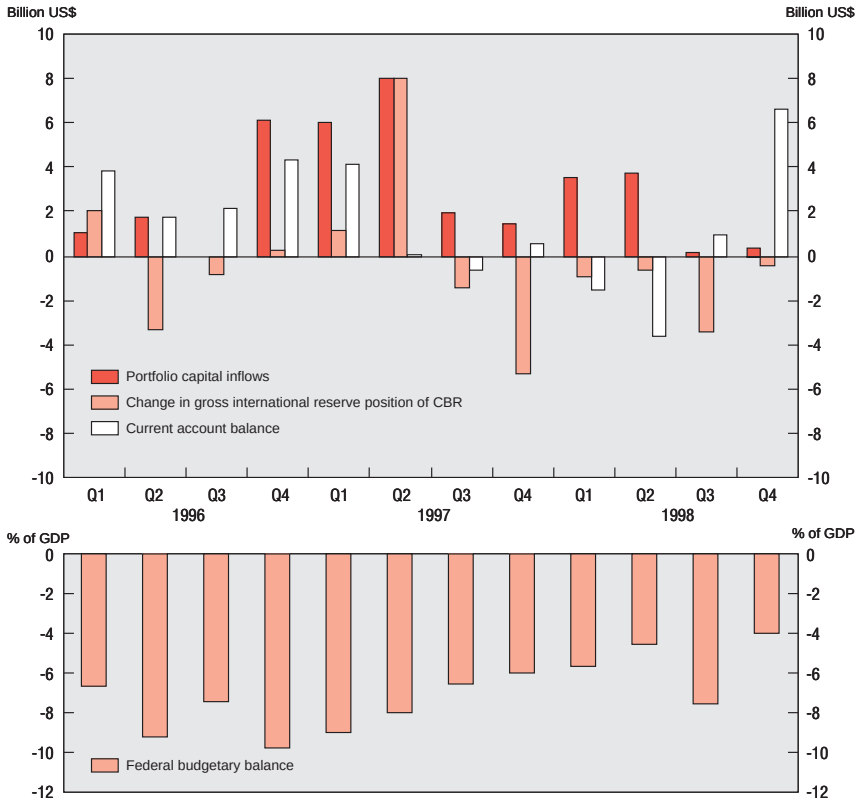
While praising some recent accomplishments, the 1997 *OECD Economic Survey of the Russian Federation* nevertheless identified unsustainable trends in the fiscal sphere at all levels of government, which were visible in widening budget deficits, a spiral of official debt, and an increasing reliance on money surrogates in budgetary operations. The *Survey* also emphasised the structural roots of these worrisome fiscal trends, including a poorly functioning tax system and a lack of clarity in fiscal federalist relations. Myopically focused "emergency", and often extra-legal, federal tax collection drives contradicted the vital goal of creating a workable tax system, consistent with strong incentives for profits and tax compliance. They also further weakened the position of creditors other than the state with regard to insolvent enterprises, a factor that hindered commercial banks in developing profitable loan portfolios and fulfilling their role as financial intermediaries. In this context, in spite of impressive progress in the regulation of commercial banks between 1994 and 1997, most banks came to depend on large portfolios of government securities or special financial co-operation with state organs. In addition, the *1997 OECD Economic Survey* documented an increasing concentration of financial and economic activity in large financial-industrial groups, many of which operated on the basis of special relations with government institutions. A corresponding lack of transparency in privatisation, competition, and other economic policies, together with high and unstable taxation, contributed to a depressed environment for domestic and foreign fixed capital investment. Consequently, the substantial inflows of foreign capital to Russia in late 1996 and the first half of 1997 consisted largely of short-term portfolio investments, primarily in government securities (GKO).

On the basis of this assessment, the 1997 *Survey* concluded that "the economy will not take off without further, deep reforms." It emphasised the necessity of major tax reform, progress in fiscal federalist relations, the improvement of the environment for fixed capital investment, changes in bankruptcy legislation and procedures, and general measures to promote the rule of law and fair competition. The *Survey* expressed hope that a strong reform mandate from the 1996 presidential elections, together with relatively low and stable inflation, success in restructuring the foreign debt, and some favourable developments on financial markets in early 1997, would provide a window of opportunity for major progress in this vital structural reform agenda. ■

What caused the 1998 crisis and how strong is the economic recovery?

The special window of opportunity in 1996-97 proved very limited indeed. The stock market crashed in late October 1997, followed by a halt in capital inflows and growing pressure on the rouble. Domestic interest rates soared, generating a rapid spiral of government debt and, eventually, a general financial crisis in mid-1998. Two major external factors contributed to this alarming turnaround in Russian financial markets, both of which were related to the financial turmoil in Asia: sharp falls in the prices of key export commodities and more cautious general attitudes of investors toward emerging markets. The underlying fiscal imbalances and structural problems summarised above made the economy highly vulnerable to such changes in the external environment. Indeed, the entire programme for fiscal consolidation and debt management in 1997 assumed that recently achieved relatively low interest rates on government bonds would be maintained. In the Russian context, this implied an assumption that the strong capital inflows would continue. Capital inflows, together with a strong current account surplus, had essentially financed larger fiscal deficits in 1996 and 1997. Once these inflows ceased and the current account weakened, monetary policy

Short-term capital flows, current account balance and the federal deficit



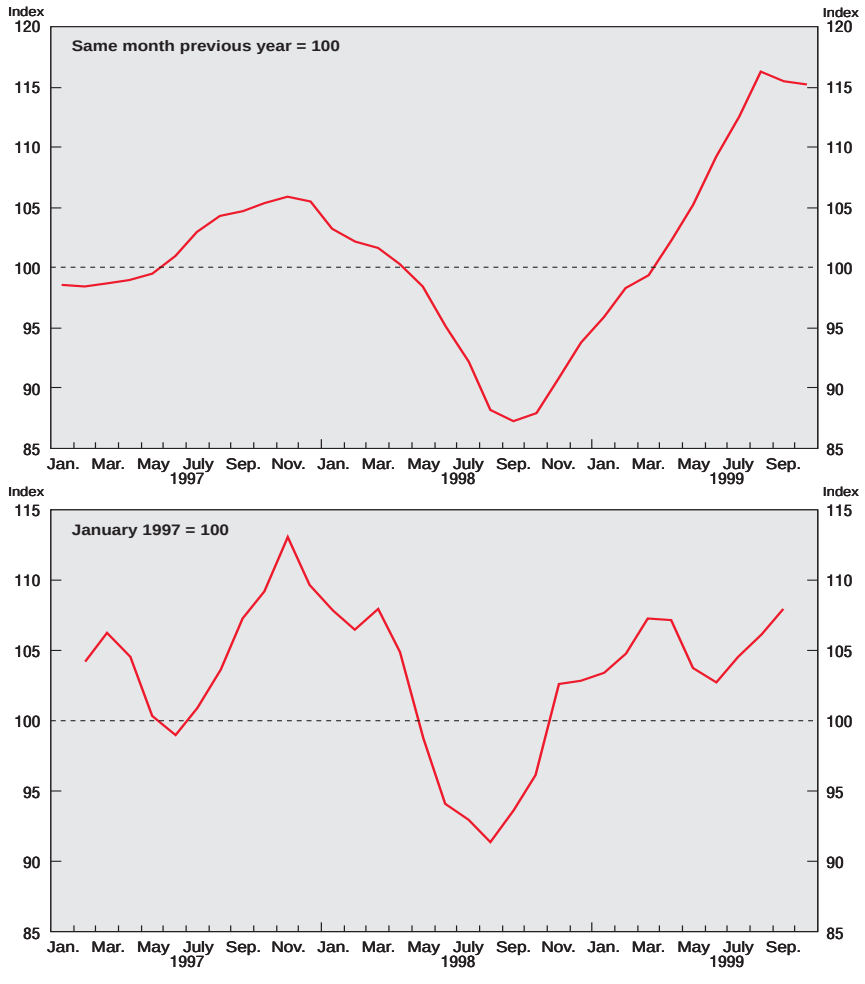
Source: Ministry of Finance, Central Bank of Russia, OECD calculations.

commitments became inconsistent with the large fiscal imbalances.

In addition to its direct adverse effect on many areas of structural reform, the crisis of August 1998 diverted much of the government's attention away from medium-term objectives in favour of emergency measures to restore macroeconomic stability. Following the rapid depreciation of the rouble and the virtual collapse of financial markets in the second half of 1998, the government and Central Bank acknowledged a genuine threat of hyperinflation, and have managed to avert this threat through rather restrictive macroeconomic policies. The effectiveness of these policies has been supported by a major strengthening in the current account, following a decline in imports of over 40 per cent. After a period of very rapid depreciation and inflation, monthly inflation has fallen to under 3 per cent since February 1999, while the rouble has been stable at around 25 to the dollar for most of the year.

The 1995 Law on the Central Bank had granted significant independence to monetary authorities and limited their objectives to the defence of the currency, the efficient operation of the payments system, and bank regulation. Since the crisis, however, the Central Bank has come under political pressure to adopt a monetary policy strategy that includes the broader aim of stimulating real economic activity. The management of the Central Bank has so far resisted this pressure and continues to pursue independent policies consistent with the objectives of the 1995 law. In the current Russian context, the preservation of Central Bank independence is important for the achievement of macroeconomic stability and restoration of the credibility of monetary policy. The current demands on monetary policy are already enormous and the degree of macroeconomic stability remains fragile. International reserves are still low and have come under constant pressure from the demands of foreign debt service.

Following the dramatic depreciation of the currency, the burden of foreign debt has become so high as to make the servicing of all scheduled payments unfeasible. Indeed, such a strategy would have devoted the equivalent of over 80 per cent of planned federal tax revenue in 1999 to foreign debt service alone. Instead, the Russian government has been following a strategy of servicing only the part of foreign debt incurred by the Russian Federation itself, as opposed to the inherited debt of the Soviet



Source: Goskomstat, OECD calculations.

Union. Negotiations are continuing on debt restructuring agreements that Russia needs to get back on track and boost its credibility with the international community.

A weaker rouble has provided a foundation for an industry-led recovery in GDP. After declining sharply in the context of the crisis, industrial output began to recover rather quickly in late 1998. The speed of this recovery is explained in part by the low historical dependence of most Russian firms on external finance, a factor that limited the impact of the financial and banking crisis on the real sector. GDP reached its pre-crisis level by mid-1999, fuelled by an expansion in both export-oriented and import-substituting industries. The relatively rapid adjustment of industrial firms to the new economic conditions gives evidence of genuine progress toward the creation of a market economy in the Russian Federation. In addition to the weaker rouble, the industrial recovery has received an additional boost from favourable movements in some key Russian export prices during 1999.

While the industrial recovery represents a generally healthy response to the depreciation of the exchange rate, some of the factors supporting this expansion may be only of a temporary nature. Increases in controlled energy and transportation prices have lagged far behind producer and consumer price inflation, leading to probable price distortions that support energy-intensive manufacturing firms, and raising questions about the overall quality of the industrial recovery. A stronger current account and restoration of "normal" rouble demand have led to a real appreciation of the rouble since the second quarter of 1999, a process which may eventually contribute to a slowing of the industrial expansion. As another constraint on growth, fixed capital investment has not recovered along with output in 1999, remaining close to its depressed 1998 level. The activity of small entrepreneurs and busi-

nesses appears also continued to suffer in 1999.

In the context of economic recovery, some real appreciation of the rouble is natural and should be expected by the Russian government. Given the current constraints on macroeconomic policy, an attempt to control the real exchange rate explicitly would likely have very limited success, and could further jeopardise economic stability. The repressed input prices for industrial firms may be associated with substantial economic costs. While some manufacturing firms may profit from the maintenance of low energy and transportation prices, a large wedge between domestic demand and supply for these commodities will entail distortions, losses in economic welfare, and an increase in administrative allocation and corruption. Artificially low domestic energy prices may also weaken incentives for restructuring toward energy-efficient technologies, a particularly important task given the nature of the inherited infrastructure from the USSR. Finally, the combination of weak financial markets, high export taxes, and repressed domestic energy prices could deprive the energy sector of much-needed resources or incentives for investment. Thus, adjustments in controlled prices in energy and transportation should receive careful consideration.

A weaker rouble, the recovery in industrial output, and adjustments in tax policy have alleviated pressures on the federal budget somewhat in 1999. The fulfilment of a relatively austere federal budget in 1999, which prescribes a primary surplus of 2 per cent of GDP, appears to be on track. A higher rouble value of export receipts and a larger share of VAT revenue accruing to the central government gave federal tax collection a particular boost. In addition to higher overall receipts, the federal government has managed the difficult task of collecting all taxes in cash since the second quarter of 1999. This contrasts with a strong reliance on various money surrogates in the past. The pursuit of a 2 per cent primary surplus has significantly compressed non-interest expenditures in real terms, a policy that may be difficult to sustain in light of the increased distress of a large part of the population.

The nature of the Russian tax system, which is plagued by an excessive number of continually-changing tax rates, regulations, and exemptions, has long been a major thorn in the side of Russian economic transition. This system both encourages tax avoidance and depresses incentives for investment and restructuring. After many years of political confrontation and delays, a first (general) part of a tax code finally became law on 1 January 1999. The first part of the Tax Code places strong limitations on the number and type of taxes that can be employed at various levels of government. Nevertheless, the rules surrounding these various taxes, as well as exemptions, are still determined in a largely discretionary manner, either during the drafting of the annual budget or by government decree. Furthermore, the crisis has increased further the uncertainty in tax policies. Hopefully, the preliminary success of the Russian government toward fiscal consolidation in 1999 will provide an impetus toward new initiatives to create an effective and workable tax system. This includes an effective division of tax authority between different levels of government (see below).

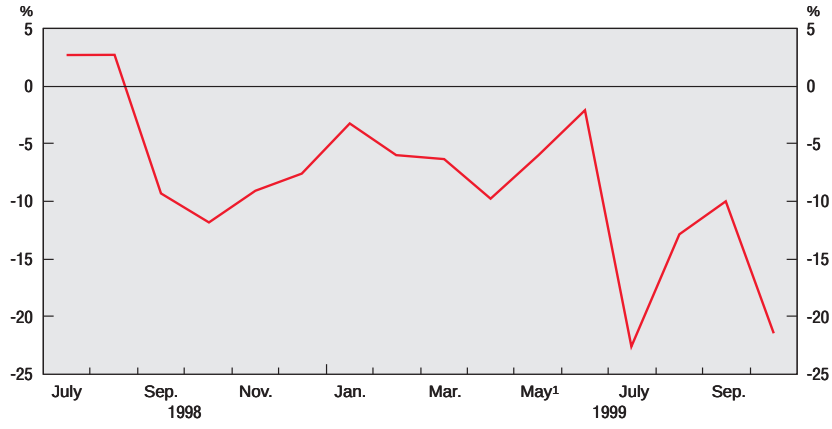
Despite the recovery in GDP, real incomes remain considerably lower than pre-crisis levels, while poverty and social distress have increased for a large part of the population. This deterioration is visible in demographic and health as well as economic indicators. The implied challenges to social policy have further exposed the weakness of the social security and health systems. Pensioners have particularly suffered from real declines in their benefits, while a major pension reform initiative of 1997-98 has been postponed in the aftermath of the crisis. Unemployment also rose substantially in the early months of the crisis, but has subsided somewhat along with the industrial recovery.

The Russian government has very limited financial means to confront the current challenges in the area of social policy, particularly given the high burden of foreign debt service and the collapse of most domestic markets for subnational debt. Real outlays on social expenditures have declined in 1999, exactly at a time of greater need. It is nevertheless important that the government continue to move ahead to the greatest degree possible with policies to target social assistance better and provide the foundation for self-sustaining pension and health care systems. The overall nominal level of pensions will need to be increased. A forthcoming *OECD Survey on Russian social policy* will offer more concrete policy advice. One general consideration regarding the division of responsibility for social expenditures is presented below in the discussion of fiscal federalist relations. ■

What are the priorities for bank restructuring and regulation?

The restructuring and regulation of commercial banks presents enormous challenges to the Central Bank and Russian government. The sharp devaluation of the rouble and virtual collapse of securities markets left the majority of large Moscow banks in financial devastation: insolvent, illiquid, under-capitalised, and loss-making. In the immediate aftermath of the crisis, the Central Bank took largely successful emergency meas-

Profitability of the 30 largest Russian banks
Net profits as a share of capital



1. May 1999 value interpolated.
Source: Central Bank of Russia.

ures to restore the payments system and prevent further bank runs by the population. Since this time, the Central Bank has been burdened with two exceedingly difficult tasks in bank regulation: the liquidation or rehabilitation of insolvent and under-capitalised large Moscow banks and the close monitoring of all banks in the face of declining overall profitability and a deterioration in the quality of asset portfolios.

The rehabilitation or liquidation of the large insolvent banks has been particularly problematic. In the wake of the crisis, the Central Bank and government had neither the resources for recapitalisation, nor the political or legal leverage for confronting the tasks of bankruptcy and liquidation. Even attempts simply to withdraw the licenses of two large insolvent banks were contested and overturned in the courts. As a result, extremely little progress was achieved in bank restructuring until mid-1999. Under-capitalised and insolvent banks, while not servicing their liabilities, continued to operate under highly distorted incentives, leading to widespread asset stripping. Subsequently, the bank restructuring process has received new momentum from two new laws of February and June 1999 on the bankruptcy of financial institutions and the empowerment of a new Agency for the Restructuring of Credit Organisations (ARKO). In mid-1999, the Central Bank also finally withdrew the banking licenses from 6 large Moscow banks, beginning a now obligatory process of bankruptcy and liquidation. The Anti-Monopoly Ministry has also recently been delegated the function of monitoring competition in the banking industry and financial markets.

The new legislation places a very large amount of power and responsibility in the hands of the Central Bank and the Agency for the Reconstruction of Credit Organisations (ARKO), as opposed to other institutions with claims on insolvent banks. This is perhaps the best solution in the particular Russian context, where strong potential conflicts of interest exist between competing creditors of these banks, many of which belong to large financial-industrial groups. The Central Bank and ARKO will continue to be challenged, however, to remain objective and detached, properly weighing the interests of banks' creditors, depositors, and shareholders. They must also quickly identify problem banks, appoint qualified temporary administrators, and allocate efficiently very scarce resources for refinance and recapitalisation. The process of bankruptcy cannot begin until the Central Bank withdraws the license of the bank in question, while even small delays in this process could seriously compromise the interests of creditors or depositors. The process of bank restructuring thus promises to be a constant source of challenge for the Central Bank and ARKO, and will also be an inevitable source of controversy in coming years.

The crisis has also left a large number of banks with very limited sources of profitability. Securities, particularly government treasury bills (GKO), were a major source of banking profits before 1998. This market has virtually collapsed and risk coefficients for domestic securities have been raised considerably in prudential regulations. The crisis has also brought a significant deterioration in the quality of loan portfolios, particularly the large share of loans denominated in foreign currency. The legal and institutional environment of the Russian economy makes supporting profitable loan portfolios quite difficult for most commercial banks, while new regulations require provisions of 40 per cent even for performing loans. Aggregate commercial bank

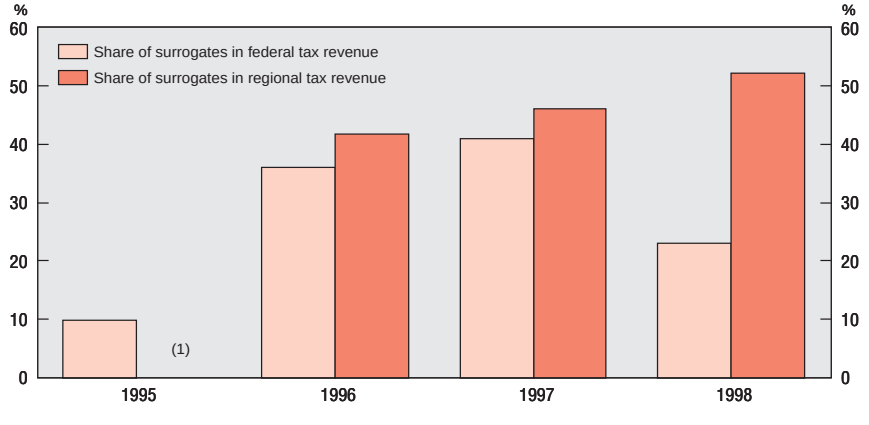
balances reveal a very high degree of liquidity, with very few new credits and a large share of assets held as cash or bank deposits in foreign currency. Aggregate profitability of the Russian banking sector remains significantly negative. Given this very problematic state of the banking sector, the Central Bank has continued to withdraw the licenses of a number of distressed banks and relaxed the former schedule for toughening minimum capital requirements and some other prudential regulations. In addition, ARKO has focused some of its attention on the rehabilitation of regional banks, many of which did not suffer the same type of decline in capital as their (larger) Moscow counterparts.

The successful reconstruction of the banking sector, including the transformation of Russian commercial banks into effective financial intermediaries, continues to require legal and institutional measures to protect the interests of creditors in the event of default on commercial loans. A new bankruptcy law of 1998 had a positive effect in this regard, as witnessed by the first active pursuit by a number of commercial banks of their claims through the court system. Complications in the application of this law to the Russian context, however, have slowed its effective implementation. According to this law and other legislation, the state receives priority claims over commercial creditors, although it is not represented in the committee of creditors that appoints external management. Given the fact that most insolvent firms in Russia have enormous tax debts, this has created incentives for creditors other than the state to appoint an external manager who pursues their interests while avoiding outright bankruptcy. While current efforts by the Russian government to amend the bankruptcy law to increase the power of the state are understandable, they might be accompanied by simultaneous measures that change the prioritisation of claims to protect at least partially the interests of commercial creditors. This protection is essential to foster the development of credit markets, healthy commercial banks and financial intermediation in Russia. ■

Why has the economy become increasingly demonetised?

A particularly alarming trend of recent years in Russia has been the "demonetisation" of economic transactions and budgetary operations. This process is associated with the rise in prominence of various forms of money surrogates, including barter, debt offsets, and various bills of exchange (*veksels*). As documented in the previous OECD economic *Survey*, this trend was already visible in 1996. By early 1998, money surrogates had mushroomed to the point of accounting for a majority of industrial transactions and subnational budgetary operations (taxes and expenditures). The rise in money surrogates has been accompanied by an elaborate system of multiple prices for the same commodity depending on transaction type. The corresponding economic costs to the economy and transition process have been formidable, and can be associated with high transaction costs, a lack of transparency in accounting and greater opportunities for corruption and illegal activities. Surrogates have also arguably impeded efficiency, restructuring, corporate governance, and the implementation of tax and other regulations. Neither state budgets nor firms have typically possessed enough cash to make basic wage, pension and other payments. The

Non-cash receipts as a share of federal and consolidated regional tax revenue



Note: Federal number is for all revenue (approximation).
1. Data are not available for share of surrogates in regional tax revenue in 1995.
Source: Ministry of Taxation, Ministry of Finance.

system of multiple prices also defies the basic logic of a market economy, as payments in kind are given a premium, as opposed to a discount, over cash payments. While some factors since the economic crisis have reduced the extent of demonetisation to some degree, the problem and its basic underlying causes remain.

A number of studies have identified several competing groups of factors that may have contributed to the demonetisation process. The *Survey* concludes that the primary causes are found in the particular conditions under which state organs and natural monopolies operate. The avoidance of commercial bank accounts that have been blocked by either tax authorities or the courts has been another possibly important factor. These conditions, in turn, are related to a number of fundamental problems in the nature of taxation, fiscal federalist relations, accounting, and the bankruptcy of large insolvent enterprises. The solution to demonetisation will therefore require a comprehensive set of measures that address the structural roots of the problem.

In the context of the multiple price system, natural monopolies, particularly gas and electricity, accept non-equivalent exchange in the form of commodities or other money surrogates at inflated values. This owes to a combination of three factors: restrictions on the ability of natural monopolies to cut off non-paying consumers, the interests of regional and local administrations in supplying firms and organisations in their jurisdictions with cheap energy, and a managerial incentive system within the natural monopolies that does not properly discount receipts in non-cash form. In this context, natural monopolies, enterprises, and subnational state administrations all have an incentive to reach an agreement that implicitly reduces payment for a firm that is difficult to cut off from supplies, while at the same time not adversely affecting the balance sheet profitability of the natural monopoly. The latter is achieved through a non-cash payment evaluated at an inflated price. For this reason, the non-cash or so-called "virtual" economy is particularly concentrated in the electricity and gas industries. ■

How can a cash economy be restored?

Part of this problem can be addressed directly through changes in accounting practices in natural monopolies. A heavy discounting of non-cash payments in balance sheet profitability would induce managers of local branches of the electricity and gas monopolies to prefer cash to non-cash receipts of equivalent value. This is far from a complete solution, however. As the power of natural monopolies to reduce supplies differs greatly for different customers (firms), the former would still be inclined to employ barter or other surrogates as a means of differentiating prices on an individual basis. From the point of view of accounting and economic efficiency, however, the appropriate policy would be to set uniform rates and demand cash payments. Under these conditions, a build-up in payment arrears of enterprises that cannot be easily cut off from supplies (*neotkliuchaemye potrebiteli*) would make the implicit energy subsidies that they receive clearly visible and transparent. Parallel measures should be taken to shift the burden of these subsidies from the natural monopolies to the budgets of state organs that are protecting these enterprises. These subsidies could be financed in part by greater cash tax receipts from the natural monopolies themselves. This would have the effect of eliminating distortions, clarifying accounting, and separating the difficult problem of the bankruptcy of large insolvent enterprises from those of the non-cash economy (demonetisation) and regulation of natural monopolies.

In addition to the natural monopolies, state organs, particularly at the regional and local levels of government, have an interest in employing at least some money surrogates in budgetary operations. This owes to many factors summarised in the *Survey*. Some primary considerations are as follows: First, as only taxpayers, and not state organs, pay interest and penalties on their arrears, state organs have an incentive to use a deliberate build-up of mutual tax and budgetary payment arrears as a means of budgetary fulfilment. Money surrogates, in the form of offsets, then emerge as a natural mechanism for clearing mutual debts at the end of the year. Second, particularly given the fact that the state treasury divides tax revenue only on a firm-by-firm basis, the use of money surrogates by subnational administrations can increase their amount and share of tax revenue received by these levels of government. Third, the fact that operations involving money surrogates, particularly offsets, are not subject to approval of parliamentary bodies or monitored by the Anti-Monopoly Ministry, make them a relatively easy mechanism for disguising corrupt or illegal activities. Fourth, the use of offsets expands significantly the degree of leverage that subnational administrations have over economic policy in their jurisdiction, including the implicit individualisation of taxation. This latter set of factors is further emphasised below in the discussion of fiscal federalist relations.

Nevertheless, the federal and some regional governments have been taking measures to limit the use of money surrogates in budgetary operations. Indeed, despite the incentives to utilise money surrogates, state administrations operating with

demonetised budgets have commonly found themselves with insufficient cash revenue to cover even basic expenditures on wages and transfers, which by law must be made in cash. A consequential build-up in wage and other arrears, together with increased official cash borrowing, has placed at least some pressure on state administrations to increase tax collection in cash. This pressure has now increased, given the current difficulties on domestic financial markets that limit official borrowing. The federal government has substantially reduced its reliance on money surrogates in 1999. Some regional governments have also made progress in this area, although the record is very uneven.

Further policy adjustments to alleviate the chronic problem of money surrogates in budgetary operations, as well as that of payment arrears, could include several measures. First, symmetric conditions should be introduced under which government organs should be forced to pay interest on their arrears under conditions similar to those for taxpayers. Otherwise, state organs at all level of government will continue to operate under strong incentives to delay payments, as well as (possibly) the processing of tax documents whenever possible, then employing offsets eventually to clear mutual debts. While such a rule may cause some short-run difficulties for budget management, it is a necessary condition for improving the current highly dysfunctional relations between state and economic organisations. Second, to the degree that the state treasury continues to divide tax revenue between various budgets, the division rule should be adjusted to account more fully for revenue received in the form of offsets. In particular, the current strict firm-by-firm division rule should be changed in the direction of accounting for aggregate cash and non-cash tax revenue in a particular region.

A huge debt overhang of tax arrears, which built up very quickly between 1995 and 1998, has complicated the conditions for solving payment and demonetisation problems. Indeed, the blocking of bank accounts by tax authorities or the courts has become an additional important incentive to rely on non-cash transactions. Particularly given the fact that these tax debts consist in large part of interest and penalties that accumulated under the asymmetric and distorted conditions described above, the current efforts of the government toward a major restructuring of this debt appear both expedient and justifiable. But this should be accompanied by simultaneous measures, as proposed elsewhere, to address the root cause of this problem, as well as a tough policy commitment to convince economic organisations that they should not expect a similar restructuring in the future. Again, the state can set the example by making its budgetary organs also responsible for executing payments on time, and levying interest and penalties on those organs that do not comply. The ultimate success of financial discipline in this area depends greatly on the further activation of the threat of bankruptcy, not only for economic organisations but for state organs as well (see below). ■

How can the disarray in fiscal federalist relations be overcome?

This *Survey* gives special attention to problems in fiscal federalist relations, which lie at the heart of a number of issues already discussed above. The 1997 *Survey* stressed problems with economic policies at the regional and lower levels of government. In comparison with most other transition economies, these policies are typically considerably less favourable toward investment, entrepreneurship, fair competition, and the rule of law. They can often also be associated with a high degree of corruption. This represents one of the primary obstacles to reform and economic growth. These problems, in turn, reflect the difficult and distorted conditions under which subnational administrations currently operate, and the poor general state of fiscal federalist relations.

Some progress has been made toward the construction of a fiscal federalist system in Russia. Relatively stable and uniform rules have replaced much of the chaotic bilateral bargaining between the centre and regions in the early years of transition, while federal transfer policies have improved, gaining at least a small degree of stability and transparency. The explicit quantitative division of budgetary revenue and expenditures between the federal and subnational level in Russia now resembles that of many developed federalist countries. Nevertheless, the entire system of fiscal federalist relations in Russia remains largely in disarray. Recent years have witnessed a striking and growing contrast between a formal highly-centralised fiscal federalist system and actual practice, under which a large degree of financial authority is exercised at the subnational level through informal channels. The reform of fiscal federalist relations continues to be a critical, as well as politically and economically complicated, aspect of economic transition in Russia.

While roughly half of all consolidated government revenue in the Russian Federation accrues to the subnational budgets, less than 20 per cent of subnational revenue comes from sources that could be considered autonomous in any sense. The vast majority of (explicit) subnational revenue is determined on the basis of laws and regulations of the superior level of government, while a single (federal) State Tax Ministry collects all taxes. While the rules that determine the division of revenue and transfers

between the federal and regional (Subject of the Federation) level of government exhibited at least some degree of stability during 1995-97, major tax changes introduced in 1998 and 1999 have once again increased the degree of uncertainty. Furthermore, the rules for the division of revenue between the regional and local levels of government are continually changed and determined on an individual basis. A law of 1997 attempted to address this problem to some degree, but appears not to have had a major effect for various reasons. The first part of the new Tax Code reiterates severe limitations in the explicit autonomous tax authority of subnational governments. While these restrictions were understandably motivated by a proliferation of many seemingly irrational subnational taxes between 1994-96, it is doubtful that such severe formal restrictions on subnational tax authority can be implemented in any practical sense (see below). The proliferation of subnational taxes before their ban in 1996 may have been more indicative of a symptom than of the disease itself.

Ambiguity in expenditure assignments has plagued the development of fiscal federalist relations in Russia throughout the transition period. These assignments continue to remain highly unclear in many areas, with subnational levels of government often financing a part of expenditures under federal responsibility and the federal government assuming at least implicit responsibility for some expenditures at the subnational level. The delegation of the vast majority of social expenditures to the subnational level has been highly problematic for at least two reasons: the relative weakness of subnational budgets in the most socially-distressed regions and political pressure on the federal government to insure implicitly a large portion of these expenditures. Second, and perhaps most important, the expenditure side of subnational budgets has been increasingly victimised by unfunded federal mandates. The sheer number and size of these mandates makes their fulfilment at the regional level simply unfeasible. Despite a law of 1993 that forces the federal government to delegate unfunded mandates only on a recommended, as opposed to obligatory, basis, sufficient legal ambiguities have led the courts to rule on many occasions that such mandates are indeed obligatory. After such a ruling, the accounts of local authorities are typically impounded for the satisfaction of a particular group of claimants. As with the revenue side of the budget, this state of affairs, together with numerous other federal norms and regulations affecting regional and local expenditures, leaves little explicit room for manoeuvre by subnational officials.

This highly centralised formal system stands in sharp contrast to the significant degree of *de facto* autonomy that Russian regions have acquired since the outset of economic transition. As the formal system does not recognise this authority, regional financial policies are realised largely through informal mechanisms. In fact, ironically, both the high level of centralisation and unfeasibility of the formal system actually serve the interests of many regional officials. It affords subnational administrations an excuse to absolve themselves of the responsibility for the execution of the (formal) budget, and instead concentrate their energies in the informal arena. As emphasised above, the extensive use of money surrogates has been one primary means for the realisation of independent subnational policies that bypass the formal system. Another mechanism can be associated with the diversion of revenue, through various means, into a number of extra-budgetary funds and accounts. Some of these funds are officially "voluntary", although, in practice, subnational authorities have the power to make "contributions" to such funds either profitable or obligatory. Regional and local administrations also participate directly in the capital of many firms and financial organisations in their jurisdictions. In the absence of a legal framework of bankruptcy for a Subject of the Federation or local government, subnational governments also attracted substantial resources through various debt instruments from 1996-98, a process that culminated in the default and insolvency of numerous regions and localities in 1998 and 1999.

Thus, the recent federal strategy aimed at retrenching much of the fiscal decentralisation of earlier years on the basis of increasingly rigid regulations and mandates has apparently backfired. The existing system leaves regions with sufficient *de facto* authority to realise their own economic policies, but absolves them of much of the responsibility for formal budgetary and debt management. A workable formal system of fiscal federalist relations must therefore recognise a high degree of financial autonomy and responsibility for lower levels of government, although within clearly defined bounds. Furthermore, a clear legal concept of insolvency and bankruptcy for a subnational administration is essential for the realisation of this responsibility. This would include provisions for the introduction of temporary administration by a superior level of government in the event of insolvency, and a detailed legal investigation that could hold individual officials responsible for improper budgetary management. These measures should also be accompanied by improved and more transparent accounting methods that better

reflect various off-budget funds and accounts at the subnational level.

Despite the many advantages of fiscal decentralisation in a country the size of Russia, the particular circumstances in the Russian economy today favour accompanying greater fiscal autonomy at lower levels of government with measures to ensure a larger relative size of the federal budget. This would involve a higher degree of centralisation and more responsibility for social expenditures to the federal level, which could better account for the very large variance in social distress among Russian regions. This particularly concerns direct responsibility for the numerous federal expenditure mandates, a measure that would ensure greater rationality in the drafting or nullification of such mandates. In fact, this would make explicit a number of the responsibilities that the federal government already implicitly shares. A significant part of the so-called "regional" and "local" revenue that is currently determined by federal laws and regulation could become explicitly federal. It is also important that compensation mechanisms be strengthened to cover any further federal assignments to the subnational level.

The implementation of such a "carrot and stick" approach to the reform of fiscal federalist relations, which offers genuine autonomy to the subnational level in exchange for a higher federal share of tax revenue and expenditures, would be politically challenging. It would generally receive support from a large number of subnational administrations, which commonly complain that the federal government takes insufficient responsibility for the needs of the region in the absence of adequate local resources. Richer regions could be more difficult to win over, but they should also appreciate the advantages of much more autonomous tax policies in the future stemming from higher income levels or resource bases. Some opposition may come from the large number of officials who profit from current arrangements, enjoying substantial rents from the combination of informal fiscal authority and a lack of formal responsibility. Given the very mixed past record of the federal government in honouring its various commitments, convincing the regions of the credibility of this proposal will also be difficult.

A complicated question for the further development of fiscal federalist relations concerns the degree to which the independence of local budgets should be protected relative to those of the region (Subject of the Federation). The large size of most Russian regions, together with a common absence of a progressive political orientation at the regional level, makes this a particularly important direction for policy and reform. To what degree could a widespread application of federal authority and coercion for the protection of local from regional budgets be efficient and practical? As illustrated in the *Survey*, limited federal attempts to address this problem in recent years have been seriously flawed, and actually may have been counterproductive. The particular nature of localities and local budgets is so varied within Russia as to make the application of uniform principles of independence very difficult. Nevertheless, the provision of a basic legal framework that protects, at least to some degree, the independence of local budgets should indeed be of federal responsibility. But the improvement of interbudgetary relations between local governments and Subjects of the Federation will depend greatly on solving the current problems in the federalist relations between the latter and the federal government. Once incentives for responsible budgetary management are established at the regional level, some administrations of the Subjects of the Federation may themselves become motivated to work toward straightening out problems with the localities in a manner that avoids excessive centralisation and takes accounts of local conditions and information.

The Russian government is currently undertaking important reforms to make federal transfers to the regions more transparent and stable over time. These measures have elevated the Federal Fund for Support of Subjects of the Federation (FFSSF) to be the main channel for the distribution of transfers and are making the methodology for the allocation of this fund more stable and economically rational. This serves to combat the perception at the regional level that levels of transfers will be adjusted in a "soft" manner to measures of past budgetary performance. Under new changes in methodology, a larger share of the FFSSF is also devoted to the poorest and most needy regions. This is an important direction of reform that has already improved the nature of federal transfer policies. The implementation of general measures to improve fiscal federalist relations, as summarised above, will give this area of policy an additional boost. The current very high degree of formal centralisation of fiscal authority and responsibility hinders the ability of the federal government in its efforts to separate transfer policies from the day-to-day needs of regional budgetary balance. ■

For further information

Further information on the *Survey* can be obtained from John Litwack, e-mail: john.litwack@oecd.org, tel.: (33-1) 45.24.90.38, and Douglas Sutherland, e-mail: douglas.sutherland@oecd.org, tel.: (33-1) 45.24.15.65. ■

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- **OECD Economic Surveys:** Economic Surveys review the economies of Member countries and, from time to time, selected non-Members. Approximately 18 Surveys are published each year. They are available individually or by subscription. For more information, consult the Periodicals section of the OECD online Bookshop at www.oecd.org/bookshop.

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- **Additional Information**: More information about the work of the OECD Economics Department, including information about other publications, data products and Working Papers available for downloading, can be found on the Department's Web site at www.oecd.org/eco/eco/.

- **Economic Outlook No. 66**, December 1999
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A preliminary edition is published on the OECD Web site approximately one month prior to the publication of the book: www.oecd.org/eco/out/Eo.htm.

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FRANCE
OECD Headquarters
2, rue André-Pascal
75775 PARIS Cedex 16
Tel: 33 (0) 1 45 24 81 81
Fax: 33 (0) 1 45 24 19 50
E-mail: sales@oecd.org
Internet: www.oecd.org

GERMANY
OECD Berlin Centre
Albrechtstrasse 9/10
D-10117 BERLIN
Tel: (49-30) 2888353
Fax: (49-30) 28883545
E-mail: berlin.contact@oecd.org
Internet:www.oecd.org/deutschland

JAPAN
OECD TOKYO Centre
Landic Akasaka Bldg
2-3-4 Akasaka, Minato-Ku
TOKYO 107
Tel: (81-3) 3586 2016
Fax: (81-3) 3584 7929
E-mail: center@oecdtokyo.org
Internet: www.oecdtokyo.org

MEXICO
OECD MEXICO Centre
Edificio Infotec,
Av. San Fernando No. 37
Col. Toriello Guerra
Tlalpan C.P.
14050 MEXICO D.F.
Tel: (525) 528 10 38
Fax: (525) 606 13 07
E-mail: ocde@rtn.net.mx
Internet: rtn.net.mx/ocde/

UNITED STATES
OECD WASHINGTON Center
2001 L Street N.W.,
Suite 650
WASHINGTON D.C. 20036-4922
Tel: (1-202) 785 6323
Fax: (1-202) 785 0350
E-mail: washington.contact@oecd.org
Internet: www.oecdwash.org
Toll free: (1-800) 456 6323

80703