Background

1. Relations between the federal government, the regions, and local governments have presented one of the greatest challenges for the economic and political transformation of Russia. Beginning with the extreme centralization of the Soviet period, Russian regions and republics became increasingly independent and assertive in the 1980s, thereby filling the vacuum left by declining central power. Economically rich or ethnically non-Russian regions often became particularly independent and, in some cases, openly defiant of the central government.

2. Two legislative acts passed in 2003 have had a significant impact on the country’s administrative and political structure as a Federation. The first is a Law that introduced revisions to the existing Federal Law on the General Principles of Organization of Legislative and Executive Organs of Power of the Subjects of the Federation, entered into effect on January 1, 2005. The second is a Law on the Organization of Local Self-governance that entered into effect on January 1, 2006 (transitional arrangements have been effective since the Law was promulgated in October 2003). This Law has introduced a fundamentally new blueprint for the country’s administrative structure on the local level, with corresponding implications for higher levels of government.

3. Overall, the approach to the organization of local government that is set out in the Law clarifies intergovernmental relations but reduces flexibility for local arrangements. The new Law clarifies the structures within the region, and makes it somewhat easier for the federal center to propose legislation related to local government as a whole. In theory, this should help to rationalize expenditure assignments and revenue allocations. In practice, however, it remains to be seen whether the application of a similar structure across vastly different regions in terms of size, wealth, and ability to deliver services will be implemented effectively. Certainly, the imposition of a local government structure from the center reduces the federal nature of the system in which regions could determine the system that would work best for them.

4. The laws embodied in the recent reforms also specify the responsibilities of each level of government, including the new tiers in local government. A few items are particularly noteworthy. Under the new laws, determination of public wages is the responsibility of each level of government, as opposed to being determined by the central government. This allows localities some discretion in controlling their wage bill. Subsidies to agriculture are now provided at the regional level, whereas subsidies to other non-state-owned enterprises are determined and provided by the central government. A very important change, one that is key to reducing unfunded mandates, is that regions are now responsible for determining and funding many social policies, including child allowances, support to the disabled, low-income families, orphans, and the like.

5. The Republic of Tatarstan, one of Russia’s 89 subjects of the Federation and one of the most autonomous regions, has entered the final stage of a long process of normalization of its relationship with the federal center. In 1994, the Republic of Tatarstan and the federal government signed a Power-Sharing Treaty that formalized special tax and budgetary conditions in Tatarstan relative to other regions. This treaty was renewed for a five-year period in 1999, although the special status of Tatarstan was diminished. The
treaty is now being phased out altogether in keeping with President Putin’s policy of standardization of federal-regional relations. In 2000, the Russian government established the Federal Targeted Program, “Socio-economic Development of the Republic of Tatarstan to 2006”. The program’s aim was to assist the Republic in its transition to “normality,” and to partly compensate for losses in revenues associated with the change in federal-regional relations.

6. As part of these changes in the Republic of Tatarstan, the city of Kazan acquired the legal status of a municipality in September 2004 and faced several challenges. Like all other Russian municipalities, Kazan faced a systemic risk of limited control over revenue sources and overdependence on intergovernmental transfers. Secondly, the city was extremely dependent on the decisions of federal and Tatarstan authorities with respect to capital expenditures. In 2005, Tatarstan and Kazan graduated from the program and such transfers ceased to exist. Pressing capital needs, such as repair of educational institutions, social protection facilities, health care institutions, and social housing could not be met without additional financing.

7. With these changes in the decentralization framework and in line with its new status within the Republic of Tatarstan, the city has undertaken reforms in several key areas: (i) improvements in municipal financial management through better financial planning, treasury control, gradual phasing out of overdue payables, better public procurement practices, and better management of municipal assets; (ii) improved targeting of social protection through the monetization of in-kind benefits and concentration of subsidies on vulnerable groups; and (iii) improvements in housing and utilities management through the elimination of budget subsidies to enterprises in district heating and the privatization of housing maintenance services.

8. To aid this reform effort, the Russian Federation requested a USD125 million Kazan Municipal Development Loan (KMDL) to enable it to provide support to the municipality’s reform effort. These funds were to enable an efficient financial and economic transition to the city’s status as a full-fledged municipality of the Republic of Tatarstan. The loan was made to the Russian Federation and then passed on as a grant to Kazan.

I. Recent Economic Developments

9. Russia finds itself in an excellent macroeconomic position in the second half of 2006. High world prices for hydrocarbon exports and strong expansion in internal demand continue to drive economic growth in Russia. Although a slowdown in most manufacturing and tradable sectors became visible in 2005, the second quarter of 2006 was marked by a strong acceleration of GDP growth that reached 6.5 percent in the first half of the year. 2006 also witnessed a substantial increase in domestic and foreign direct investment, which reflected Russia’s positive economic outlook and some improvements in the business climate. FDI inflows grew by 55 percent during the first three quarters of the year, reaching an estimated USD 10.3 billion. With the federal government running a substantial budget surplus (about 8.7 percent of GDP), official Russian external debt was reduced from USD 106 billion in 2004 to below USD 50 billion by the end of third quarter of 2006. Gross foreign reserves continued to set records reaching USD 272.5 billion by the end of October 2006. The Stabilization Fund has accumulated over 2 trillion rubles (USD 77 billion) by the end of October this year and could accumulate another USD 10-15 billion by the end of the year.

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2 Federal Targeted Programs in Russia are a planning tool used to identify priorities for the federal budget over a multi-year period that by design stipulate the identification of other sources of financing, e.g. regional and local budgets and private investors.

3 Previously, Kazan was an administrative division of the Republic of Tatarstan.
10. However, the medium and long-term prospects for sustaining today’s growth rates remain heavily dependent on volatile natural resources prices. Russia’s growth performance in particular benefited from high prices for hydrocarbon exports. The average export price of Russia’s oil in the first seven months of 2006 was 56 USD/bbl compared to 45.2 USD/bbl in 2005 and 34.1 USD/bbl in 2004. Overall, the economy’s assets remain concentrated in the extractive industries, with exports almost entirely dependent on natural resources. Sector distribution of investment flows also raises some concerns. While absolute investment levels remain low in Russia relative to emerging markets (18 percent of GDP in 2005 in Russia and 25 percent and higher in countries that have sustained rapid growth), investment remains concentrated in oil and gas, most manufacturing sectors of the economy receive rather low shares of investment and FDI. To ensure sustainable improvements, the government focused on the implementation of four National projects - in health, education, housing and agriculture - directly targeting the standard of living of the population by combining higher spending in these areas with certain structural reforms.

11. **Industrial growth:** Though industrial growth in Russia contracted to 4 percent in 2005, down from 8.3 percent in 2004, it has slightly increased to 4.3 percent during the first ten months of 2006, being accompanied by a substantial increase in domestic investment. Aggregate fixed capital investment continued its strong double digit growth - at 12.6 percent in January-October 2006 (compared to 10.5 percent in 2005). But the structural composition of growth has undergone some significant changes. If the growth in 2003-2004 was led by oil and some other industrial sectors, subsequent growth has shifted to the production of (largely) non-tradable services and goods for the domestic market. Almost 50 percent of the GDP expansion in 2005 came from trade and construction. In spite of relatively low growth in manufacturing (4.7 percent in ten months of 2006) there have been some positive trends observed since 2005. Several industries which produce tradable goods reported observable increases in their production during 2006. The biggest increase in real output was reported by light industries, where textile and sewing grew 7.8 percent and production of shoes and leather products increased by 13.2 percent. Both industries had been reporting negative growth rates for the last several years. The negative trend, however, continued in machine building and production of electro-technical equipment. The production of electro-technical equipment has fallen by 1.5 percent in January-October 2006, while the production of machines and equipment increased by only 0.5 percent.

12. **Inflation and Exchange Rate:** Concerns over inflation have brought an important change in monetary policy. While the Central Bank defended a relatively stable exchange rate of the ruble versus the dollar during most of 2005, it has allowed a 6.4 percent nominal appreciation in the first half of 2006. Moreover, in early 2006 the government launched preparation of a package on anti-inflationary measures in the context of proposals that include price controls, restricting wage growth in the state-owned companies, restricting borrowing by state-owned companies, and reducing state expenditures. The CPI inflation in 2006 appeared to be at a moderate level - at 7.5 percent for January-October, compared to 9.2 percent for the same period of 2005.

13. **Terms of Trade:** International trade in 2006 was characterized by a considerable continued growth of exports and imports. Export of goods reached USD 224.1 billion in January-September 2006 (compared to USD 174.6 billion in the corresponding period of 2005), and imports reached USD 112.7 billion (compared to USD 87.5 billion in 2005). The record increases and current account surpluses owe almost entirely to price increases on Russian exports, most particularly for oil and gas. Russia’s trade surplus reached USD 111.5 billion in January-September 2006, as compared to USD 87.4 billion in the same period of 2005. While export growth was driven by exceptionally high prices for Russia’s main export commodities, import growth resulted from the continuing appreciation of the ruble, combined with a rapid increase in real incomes and purchasing power.
14. **Federal Budget:** According to the Ministry of Finance estimates for the first nine months of 2006, the Federal Budget was executed with a surplus of 1685.5 billion rubles, or 8.7 percent of GDP on a cash basis. Federal budgetary revenues amounted to 4557 billion rubles or 23.5 percent of GDP, which is by 0.6 percent lower than in the first nine months of 2005. This decline, however, is mostly explained by additional tax revenues that the federal budget received from Yukos at the beginning of 2005. If the repayment of tax debt by Yukos is excluded, total revenues in 2006 exceed the corresponding revenue level in 2005 by about 1 percent of GDP. The main factor for increased revenues has been higher energy prices which helped to increase non-tax revenues, while tax revenues registered a sizable decline due to mostly reduction in VAT collection. The Federal government expenditures were reported at only 14.8 percent of GDP for the first nine months of 2006 (2871.5 billion rubles), considerably lower than 16.5 percent in the same period of 2005. The amendment to the Federal Budget for 2006, approved by the government at the beginning of November, envisages an increase in spending by 161 billion rubles (0.6 percent of GDP), while revenues are planned to increase by 1.1 trillion rubles (4.2 percent of GDP).

15. **Income, Poverty and Labor Market Indicators:** News on the standard of living in Russia is still encouraging. Average real wages and incomes continued to exhibit strong growth in 2006, registering at 13.2 and 11.5 percent respectively during the first ten months of the year. Given the strong appreciation of the ruble, dollar wages grew much more rapidly than real wages in 2006 and averaged USD 381 a month, a 30.5 percent increase over 2005. Unemployment rates also continued to fall, averaging 7.5 percent for the first ten months of 2006, as compared to 7.6 and 8.2 percent in 2005 and 2004, respectively. Demographic statistics for 2004 indicate that the disturbing rise in mortality rates may have finally bottomed out. Life expectancy increased from 64.3 to 65.8 years. Although official data on poverty are not yet available for 2005 and 2006, indirect indicators suggest that growth in Russia remains strongly pro-poor. Thus, it appears that the share of people with incomes below the subsistence level will decline to below 15 percent by the end of 2006.

16. **Creditworthiness:** Russia’s macroeconomic performance resulted in rating agencies upgrading their sovereign credit risk. Moody’s raised Russia’s sovereign risk from Ba2 to Baa3 (with “stable” outlook), and Standard and Poor’s - from BB to BBB - for local currency borrowings and BB+ for foreign currency borrowings (with “stable” outlook). Thus, Russia was, for the first time in its history, given an investment grade rating by Moody’s. Aside from good fiscal performance and large trade surpluses, rating agencies emphasized political stability, progress in macroeconomic management, the continued implementation of tax reform and the level of foreign reserves. On the negative side, the sustainability of Russia’s growth was perceived to be highly dependent on international oil and gas prices.

17. As for the Republic of Tatarstan, its social and economic development has been generally corresponding to federal trends. Tatarstan has been growing steadily with the rate slightly above the Russian average. During 2001-2005 the cumulative GRP growth amounted to about 34% and its share in the country’s GDP in 2005 was about 2.5%. Average real incomes of the population were lower than the Russian average (6,997 rubles and 7,848 rubles respectively in 2004), however, the subsistence level is considerably lower in the Republic due to lower housing services and transport prices. Poverty indicators in Tatarstan are close to the national level - about 20% of the population is living below the subsistence level, however, a big share of rural population (24.6%) makes a considerable contribution to the overall poverty indicators.

18. In sum, the present macroeconomic framework is satisfactory for disbursement from the KMDL at this time.
19. The release of the second tranche is contingent, pursuant to Section 2.02 (d) of the Loan Agreement, upon progress satisfactory to the Bank with respect to: (i) progress achieved by the Borrower and the City in the carrying out of the Program of actions to strengthen and reform the economy of the City; (ii) maintaining the satisfactory macroeconomic policy framework of the Borrower and the City; and (iii) specific core conditions described in Schedule 3 to the Loan Agreement of June 3, 2005. Progress in terms of the macroeconomic framework is described in paras. 9-16 above.

20. Progress in carrying out the Program has been satisfactory, and there has been no reversal of the actions taken in compliance with the first tranche of the Loan. In addition to meeting the specific tranche conditions, described below, the City demonstrated substantial progress in reforming all core areas as outlined in the Letter of Development Policy, including strengthening the budget and financial management, improvements in public procurement and municipal property management, improved delivery of social services through institutional development, monetization of social payments and increased targeting of assistance to the poor, and reforms in the housing and communal services aimed at fiscal sustainability and increased competition in the sector.

21. There are nine specific core conditions for the second tranche, as specified in Schedule 3 of the Loan Agreement. Seven of them have been fully met, one condition has been substantially met, and one condition has become redundant, as described below:

**Condition 1. The 2006 fiscal year budget with the concept and parameters satisfactory to the Bank has been approved by the City.**

22. **Condition met.** In all material aspects this condition has been met, though the expenditure levels and patterns of 2005 made implementation of this condition very difficult and in some cases mitigating and follow-up measures were necessary as detailed below.

- The city made significant efforts to help its budgetary institutions to stay in restructuring agreements with the federal social funds. Currently, of 245 budget entities only 40 entities have dropped from the restructuring agreements. To resolve this problem, an amount of 123 million rubles has been allocated in the 2006 city budget as a separate line item and was finally paid in October 2006 to cover overdue payables of these budgetary institutions (fines are expected to be restructured by federal authorities).
- In 2005, 583.7 million rubles were paid to cover the overdue payables of budgetary entities. The revised annual city budget for 2006 incorporated 402.4 million rubles that were paid in October 2006 to eliminate overdue payables of budgetary entities (other than those covered by the restructuring agreements with RF social funds), except fines which are expected to be restructured by federal authorities.
- The city unexpectedly received about 4.8 billion rubles as a federal subvention for the city metro construction. These funds were earlier supposed to be allocated directly from the federal budget. As a result the amount of total expenditures increased dramatically making it impossible for the city to maintain the agreed share of 12 percent of social capital expenditures. As of January 1, 2006, this share was equal to 7.3 percent. Without this federal subvention, this would have been almost 11 percent. To compensate for this situation, the city decided to allocate more funds for capital expenditures in education, health, and social protection in the context of 2006 budget in comparison to 2005 budget. In the 2006 city budget this share is budgeted at 15.3 percent.
- The rate of wage growth is capped by the rate of growth for federal employees.
Condition 2. The City has demonstrated that there are no new overdue payables of the city budget and budgetary institutions from end-2004 to end 2005.

23. **Condition met.** Again, in all material aspects this condition has been met, though the expenditure levels and patterns of 2005 made implementation of this condition very difficult and mitigating measures were necessary. During 2005 the arrears of budgetary institutions for previous years were reduced by 723.1 million rubles. Unfortunately, the city and its budgetary institutions accumulated new arrears by January 1, 2006 in the amount of about 316.2 million rubles. The city paid part of such arrears in the amount of 124.8 million by July 1, 2006 and fully repaid the remaining arrears in mid-October 2006.

Condition 3. The City has demonstrated that a viable system of Treasury-execution of the municipal budget has been established based on a single account concept for budgetary funds, and funds are channeled solely through the Borrower’s Central Bank.

24. **Condition met.** The city is in compliance with conditions for functioning of an efficient treasury system as described in the Minutes of Negotiations. From January 1, 2006 the single account of the city budget has been opened for the Department of Federal Treasury in Tatarstan in the territorial office of the Central Bank of Russia. The following activities are performed by the treasury: registration of consolidated budget appropriations; registration of limits of budget commitments; registration of maximum authorized cash spending amounts; allocation, control and passing information on limits of budget commitments and on maximum authorized cash spending amounts to budget users; control and registration of cash spending requests; registration of budget commitments, including contract registration; payments management; accounting for and reporting on budget execution; General Ledger keeping; information storage. Agreements between Republican and city authorities and supporting regulations submitted to the Bank demonstrate that the city enjoys sufficient control over this account.

Condition 4. The City has demonstrated improvements, satisfactory to the Bank, in the implementation capacity for social protection programs.

25. **Condition met.** In accordance with the prior conditions, 665 million rubles have been allocated and used within the social protection part of the city budget in 2005. 887.4 million rubles are allocated for this purpose in the 2006 budget. The city social protection department is fully operational, its policy setting role for social support programs is established by the resolution of the city, it operates most of the social support programs. Program monitoring tools have been designed, tested and implemented to include coordinated database, and monitoring reports framework. A staff training program has been developed and is currently under implementation.

Condition 5. The city has demonstrated that payment of monetized social and housing and communal service benefits using individual accounts has been introduced and is under implementation.

26. **Condition met.** All social and HCS benefits are monetized per principles of national legislation. All benefit payments are channeled to individual commercial bank accounts or mail accounts.

Condition 6. The city has demonstrated that sufficient resources in the form of subvention from the Republic of Tatarstan have been allocated in 2006 City budget for payment of monetized benefits.

27. **Condition met.** The 2006 budget has allocated 870 mln rubles as a subvention from the Republic for payment of monetized benefits. This allocation is sufficient to pay all monetized benefits to the city.
Condition 7. The targeted poverty benefit has been successfully implemented, and 2006 City budget allocates not less than 70 million Rubles for the City own social protection expenditures for its financing, and social contract practice is utilized.

28. Condition met. The city has implemented the targeted poverty benefit in 2005 to about 20 thousand families or approximately 5 percent of households in Kazan. In the context of the 2006 budget, the city has allocated over 70 mln rubles for the targeted poverty benefit, and revised the criteria and procedures for the administration of the benefit. The Bank has received confirmation that the program is fully budgeted for FY 2007.

Condition 8. The City has demonstrated satisfactory improvements in the housing and communal sector (HCS).

29. Condition substantially met, i.e. in the City Budget for 2006 there are (a) no budget subsidies to producers of heat; (b) funds for HCS consumption by budget organizations and optimization and leveling of heating tariffs took place, inter alia, through creation of a single sales and distribution company. The City Budget has no subsidies for heat producers and 468 million rubles has been allocated for HCS consumption by budget organizations. Heating tariffs for population throughout the city were leveled already in 2005 despite the fact that heat in Kazan has been supplied by three different producers whose production costs differ at times. The same approach to tariff setting has been extended into 2006. On July 11, 2005 an Agreement to create a Kazan Heating (sales) Joint Stock Company (KHJSC) was entered into between JSC Tatenergo, the City Administration’s Committee for Communal Property Management (KUKI) and the Ministry of Land and Property Relations of the Republic of Tatarstan as member founders. At the time of institution, the shares of the company were split at a ratio of: 72.5% (Tatenergo), 25% (City) and 2.5% (Ministry). The material assets of the newly created company include the pipeline contributed by Tatenergo and the intra-city heat supplying network contributed by Kazenergo. The Company commenced its operations on October 1, 2005.

30. Elimination of cross subsidization for the supply of water and wastewater (equal tariffs set for various categories of consumers) has not been fully achieved due to unexpected changes in the federal regulations, however certain progress has been made and firm commitments have been made by the city authorities to achieve this goal by 2008. On December 19, 2005 the State Duma of Russia passed important amendments to the Federal Law “On the principles of tariff regulation in HCS” that have taken away the right of municipalities to set tariffs for water and wastewater services and capped the annual tariff growth for population, apparently based on social considerations on the eve of the parliamentary and presidential elections scheduled for 2007 and 2008 respectively. After consultation with the Bank, the city has prepared and adopted the program of leveling water tariffs for population and enterprises by 2008.

Condition 9. The City’s water and wastewater facilities (Vodocanal) are managed by a competitively selected private operator.

31. The implementation of this condition has become redundant, as the EBRD initiated a project in support of the Vodokanal rehabilitation and management improvements. The EBRD project aims to finance the vodocanal’s priority capital investments and corporate development to improve the municipal water and wastewater infrastructure and services in the city and would involve a Russian ruble 700 million loan to the Kazan water and wastewater management utility “Vodocanal” for 10 years to be partially guaranteed by the Republic of Tatarstan with a municipal support agreement signed by the city. A pre-financing agreement with preliminary terms and conditions of the loan was signed by EBRD, the vodocanal and the city on July 19, 2006. The EBRD received on November 1, 2006 the letter signed by Mr. Rustam Minnikhanov, the prime minister of Tatarstan, confirming that the Republic of Tatarstan is ready to issue a partial guarantee to vodocanal in 2007. At the moment, the EBRD and the Republic are
negotiating preliminary terms and conditions of such a guarantee. Once approved by the legislative council of the Republic, the Republic's guarantee will be used as a security instead of the city's partial guarantee.

32. The Government of Finland has allocated a grant to fund the technical feasibility study, which currently is being prepared by the Finnish firm Poyry Soil and Water with a view of completion by end-November 2006. Consultants also conduct an environmental audit and prepare an environmental action plan for the city.

33. The European Union has allocated a grant to conduct a financial audit of the company finances and provide an independent review of the city's finances. The assignment has been completed by a consortium of the rating agency Standard and Poor's and the auditing company MCD JSC.

34. Upon the completion of the feasibility study in end-November, the EBRD will anticipate a review of the project by its Operational Committee on December 15, 2006 and to submit it for approval to the Board of Directors in December 2006/January 2007. The loan and the guarantee agreements are envisaged to be signed in January/February 2007 in this case.

35. During the implementation of the EBRD Project, institutional support will be provided, i.e. twinning of the vodocanal with an experienced corporate development support partner, most likely, a western water and wastewater utility (e.g. such program was successfully implemented between St. Petersburg vodocanal and Stockholm Water). The program will include the preparation and adoption of a corporate development plan, service agreement, tariff policy between the city and the utility, review of potential options for corporatization and comparison of these options from financial, legal, operational and tax perspectives, outsourcing potential, public awareness campaign, etc.

36. In the context of the project preparation, a detailed program of improvements in the vodocanal has been prepared by the city, coordinated with the Bank and EBRD and adopted by the city authorities.

37. Overall, the EBRD project would seem to be an excellent vehicle to better prepare the vodocanal for subsequent corporatisation and privatization.

38. Audits. The audit of the Deposit Account for the first tranche and the audit of the use of the first tranche funds have been conducted by a qualified audit company under the terms of reference agreed with the Bank. No major issues have been identified by the auditor. The audit reports have been reviewed by the Bank and some clarifications have been requested that are being currently prepared by the Borrower.

39. Conclusion and Recommendation

40. The Borrower's implementation of the Program has been very good. The macroeconomic and fiscal framework has been satisfactory during the Program period. The Borrower and the City have fully met seven out of the nine core conditions of the second tranche release, and have substantially met one more condition relating to the improvements in the housing and communal sector (except full elimination of cross-subsidization between water users that was prevented by an unexpected tariff increase caps introduced in the national legislation). Implementation of one core condition, i.e. transfer of the city's water and wastewater facilities to a competitively selected private operator, has become largely redundant as the EBRD stand alone project came on board and its expected development impact is believed to meet the spirit of this loan. It is proposed that this condition is waived. Progress in respect to non-core conditions of the program of the Letter of Development Policy has been satisfactory in all material aspects. In view of the overall performance and progress with the implementation of the Program supported by the Loan,
it is recommended that the Executive Directors approve the proposed waiver. Subject to no-objection by the Executive Directors, IBRD will notify the Borrower that the second tranche of USD 75 million has been made available for disbursement to the Borrower.