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# **RUSSIA: SUBNATIONAL GOVERNMENTS' FISCAL RESPONSE TO THE ECONOMIC DOWNTURN**



**WORLD BANK GROUP**  
Macroeconomics & Fiscal Management



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*The aim of this note is to present and analyze subnational fiscal trends in Russia in the context of overall slowing economic growth and falling oil prices over the last few years. In particular, in 2015, GDP fell by 3.7 percent. Despite efforts to cut expenditures, the federal deficit increased to 2.4 percent of GDP. Subnational governments were also affected by the economic slowdown. Aggregate subnational revenues declined, in real terms, by 6 percent between 2014 and 2015. Revenues from taxes (including shares of federal taxes) fell by 4 percent while federal transfers fell by 13 percent. Nevertheless, the aggregate fiscal performance of subnational governments actually improved over this period. The nadir of subnational government finances occurred in 2013, when the consolidated subnational deficit reached 0.9 percent of GDP. Since then, it has shrunk. In 2015, the deficit was equal to only 0.2 percent of GDP. This was largely achieved by drastic cuts in spending. Spending in the social and infrastructure sectors both fell by 9 percent in real terms between 2014 and 2015. This note examines the fiscal prospects of subnational governments in Russia, focusing particularly on the nature of these spending cuts and whether they are sustainable over the medium term.*

## STRUCTURE AND FUNCTIONS OF SUBNATIONAL GOVERNMENTS

**1. Russia has a complex structure of subnational government.** At the top level, the country is divided into over 80 federal subjects, termed *oblasts* and federal cities. Territorial subdivisions also include krais (administrative territories), republics, autonomous *okrugs* (territorial divisions), and autonomous *oblasts*. The administrative units are grouped into eight federal districts, each headed by a presidential plenipotentiary appointed by, and representing, the President of the Russian Federation, who monitors the performance of the regions in each federal district. Hereafter, all these top-level geographical units will be referred to as “regions”.<sup>1</sup>

**2. The territory of each regional government is in turn divided into what might be termed “first-tier municipalities”.** These consist of large cities (formerly known as cities of oblast subordination) and rural *raions* (districts); the latter contain a variety of forms of small towns and village governments, which this report will refer to collectively as second-tier municipalities.

There are more than 2,000 first-tier municipalities comprising more than 500 cities and more than 1,800 *raions*; and there are more than 20,000 second-tier municipalities, comprising more than 1,600 townships and more than 18,000 rural communities.<sup>2</sup>

**3. Under the current legislation, all municipalities (including rural settlements with small populations) are required to establish local governments, employ municipal office staff, formulate and execute budgets, and conduct an independent debt policy.** The law assigns a set of expenditure responsibilities to each tier of municipal government (See Box 2). In practice, municipalities tend to be highly dependent on their respective regional governments. They have limited taxing powers and are largely dependent upon transfers and shared taxes from their respective regions; as detailed below, the only major federally-designated source of revenue for municipal governments is a share of the personal income tax (PIT). As a result, the municipalities tend to function as spending agents of their respective regions, rather than an independent tier of governments.

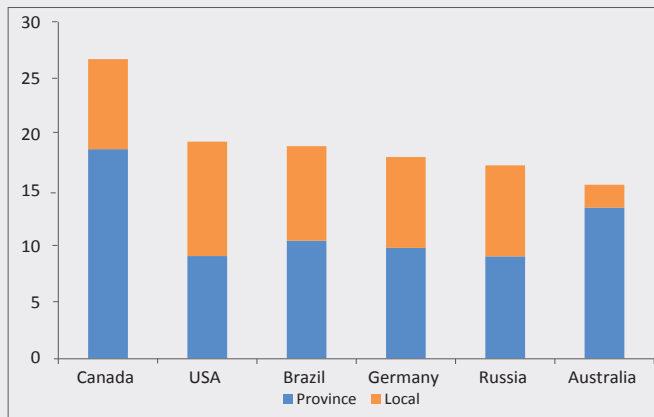
<sup>1</sup> IMF Article IV Consultation, July 2010.

<sup>2</sup> The federal cities are also divided into municipalities. Recent (2014) legislation permits other large cities to do the same.

## BOX 1: RUSSIAN FEDERALISM IN THE INTERNATIONAL CONTEXT

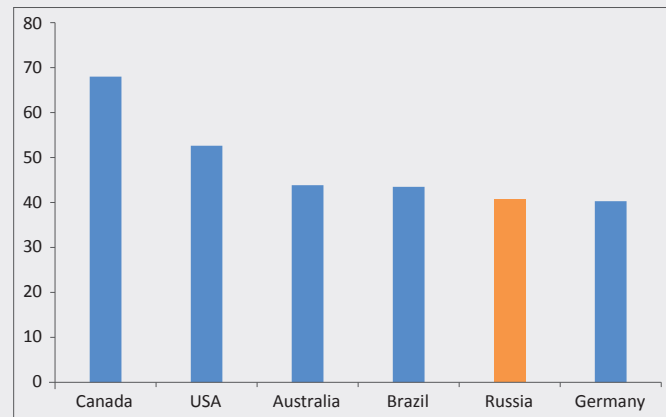
In aggregate terms, the degree of fiscal decentralization in Russia is similar to that of other large, middle-to-high income federal countries. The first figure below shows the share of total general government expenditures that are accounted for by subnational governments in Canada, the U.S., Australia, Russia, Brazil, and Germany. As shown, Russia is not unusual. It is less decentralized by this measure than the U.S. or Canada but roughly on par with the other three comparators. Another way to measure decentralization is to look at the size of subnational government as a share of GDP. Again, Russian subnational governments are not as large as those in Canada, but they are roughly on par with those in the U.S., Germany, and Brazil. Interestingly, the split in Russia between spending at the regional level and at the local (municipal) level is also similar to that in the U.S., Brazil, and Germany.

**FIGURE B1: Subnational spending, percent of general government**



Source: Federal Treasury of the RF.

**FIGURE B2: Subnational spending, percent of GDP**



Source: Federal Treasury of the RF.

Note: data is based on IMF Government Finance Statistics (except US, where it also incorporates data on local finance from the US Census of State and Local Governments). Expenditures by central and provincial government are net of transfer to subordinate levels of government. Provincial government are net of transfer to subordinate levels of government.

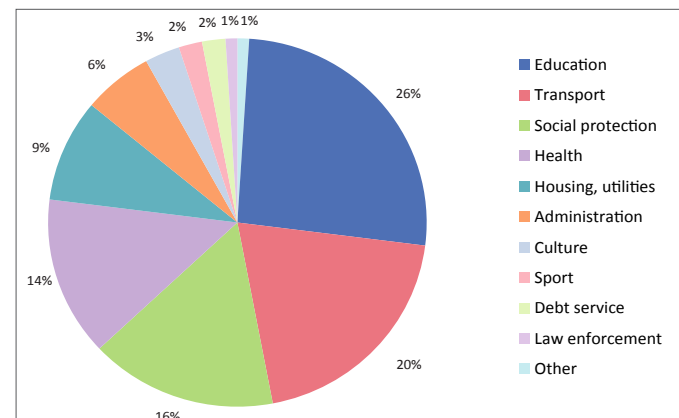
## Functions

**4. The functions of each tier of subnational government are set out in federal legislation, specifically Law 131/2003 as amended.** Subnational functions are broad ranging. They include the provision of social assistance, education (kindergartens and grades 1-11), and the operation of health care facilities (although general hospitals are largely funded by the regional divisions of the national health insurance fund). In the infrastructure sectors, their responsibilities include regional and intra-city roads. Subnational governments are also responsible for the provision of public utilities (e.g., district heating and water supply) and public transportation. In total, subnational governments account for about one-third of total government expenditure.<sup>3</sup>

<sup>3</sup> In calculating this percentage, the total is calculated as the sum of federal expenditures, regional and municipal expenditures, and expenditures of federal extra-budgetary funds (the pension fund, social security fund, and the medical insurance fund together with its regional divisions). Due to intergovernmental transfers between these entities, when estimating the shares of each entity, all intergovernmental fiscal transfers are netted out. Thus, for example, subnational spending on hospitals, financed through the national health insurance fund, are not included in 'subnational expenditures'.

**5. As shown in Figure 1, the social sectors—education, social protection and health—together account for just over half of total subnational expenditure.** (Figure 1 shows the consolidated expenditures of all three tiers of subnational government, with transfers from *oblasts* to *raions* and from *raions* to second-tier municipalities netted out).

**FIGURE 1: Composition of subnational expenditures**



Source: Federal Treasury of the RF.



## BOX 2: FUNCTIONAL ASSIGNMENTS

The following functions are assigned to the three tiers of subnational government, respectively:

### Regional:

- Providing health care in specialized hospitals (for tuberculosis, cancer, psychiatric conditions, and so on)
- Providing funds to municipalities for preschool, primary, secondary, and afterschool education
- Providing vocational education
- Protecting the environment and nature reserves
- Preventing disasters and emergencies and dealing with their aftermath
- Providing fire protection
- Providing veterinary control and anti-epidemic activities
- Providing welfare services to senior citizens and persons with disabilities
- Paying allowances to families with children and to low-income households (for housing and utilities)
- Supporting rehabilitated persons subjected to repressions and workers in defense enterprises during World War II
- Providing medical insurance for the unemployed, children, and senior citizens
- Running orphanages
- Preventing terrorism
- Constructing and maintaining regional roads and other infrastructure
- Providing intercity public transportation
- Maintaining regional public libraries and regional museums
- Organizing cultural and sports events.

### First-tier municipalities:

- Protecting the environment
- Managing waste disposal
- Maintaining raion libraries and museums
- Organizing recreational, cultural, and sports events in favor of all citizens of the raion
- Providing electricity and gas
- Constructing and maintaining intersettlement roads
- Providing intersettlement public transportation.

### Second-tier municipalities:

- Delivering housing and utilities (electricity, heating, water, gas, streetlights) and providing waste collection
- Constructing and maintaining housing for low-income households
- Providing basic fire protection
- Maintaining cemeteries
- Maintaining parks and gardens
- Maintaining settlement libraries
- Organizing recreational, cultural, and sports events in favor of the particular municipality's citizens
- Constructing and maintaining intrasettlement roads
- Providing intrasettlement public transportation.

**6. Education is the largest single functional category sector of subnational government expenditure.** Spending in this sector accounted for 26 percent of total subnational expenditure in 2015. Spending on general education (grades 1-11) is financed out of the general revenues of regional governments (as opposed to earmarked federal grants or municipal revenues). Funds to cover the recurrent costs of salaries and supplies are transferred through earmarked grants from the regional government to first-tier municipalities (*raions* and cities of oblast subordination) on the basis of formulas that largely reflect enrollment. Individual schools are managed by first-tier local governments, which are also responsible for paying for their utility costs. In 2015, responsibility for financing kindergartens was transferred from second-tier local governments to the regional governments, which now provide the necessary funds to their respective municipalities. By and large, capital costs (new school construction) must be financed out

of the general revenues of regional governments, although the federal government recently announced a \$US50 billion financing program for new school construction.

**7. Health care accounts for 14 percent of subnational expenditure.** In principle, the burden of financing subnational health care facilities falls on the national health insurance fund (HIF), which makes payments to territorial (regional) health funds, which in turn transfer funds to individual health care institutions. Funding is allocated on a case basis—i.e., according to the number of cases treated by each institution, with levels of payment varying according to the nature of the case (there are reportedly more than 5,000 separate categories of treatments). The HIF is funded from two sources: (1) employee contributions (deducted at source), and (2) payments by regional governments on behalf of people who are not required to make contributions due to their status:

the young, the old, the disabled, and the registered unemployed. The latter account for 50-70 percent of regional government health expenditures (in Vologda, payments to the HIF account for Rb 5 billion of the 8 billion that the oblast spends on this sector).

**8. It is reported that payments from the HIF are largely sufficient to cover the recurrent costs of health care facilities (supplemented by official and unofficial out-of-pocket payments by patients and their families).** This was not always the case: The current situation reflects federal decisions over the last four years to sharply increase the level of health insurance premiums. HIF payments are not, however, sufficient to cover the costs of new medical equipment or new facilities. Such costs must be financed out the general revenue of regional governments, although the federal government previously provided funding for hospital renovations and purchases of medical equipment under a program that has now expired. Regional governments are also responsible for financing the operating costs of certain specialized hospitals out of their own budgets. These include facilities for the treatment of tuberculosis, cancer, alcohol and drug addiction, AIDS, and mental illnesses.<sup>4</sup>

**9. Social assistance accounts for 16 percent of total subnational expenditure.** Spending in this sector largely consists of payments or subsidies to specific categories of beneficiaries (rather than, for example, the running costs of old age homes and orphanages). Some social assistance programs are mandated and financed by the federal government. Federal law, for example, mandates specific benefits for veterans of WWII and their surviving dependents. These are financed from the federal budget and transferred through the regional budgets to final beneficiaries. But federal law also requires subnational governments to provide social assistance benefits to other groups, without necessarily specifying the level of those benefits or providing any funding to pay for them. One of the largest (i.e., costliest) benefits (judging from evidence from the city of Moscow) consists of top-ups to (federally financed) pensions.

<sup>4</sup> The exclusion of these facilities from HIF financing is more a result of history than of policy. Over time, the HIF has been expanding the types of facilities it covers but it has not yet reached the specialized hospitals.

Regional governments, at their discretion, can make up the difference between the amount of the federal pension and the official 'subsistence' income, which varies by region.

**10. Other forms of social assistance include utility subsidies and transport subsidies.** In the case of public utilities (district heating and water supply), these subsidies take the form of individual reimbursements: beneficiaries pay the normal tariffs to their respective utilities and then seek reimbursement from their regional governments. In most cases, such subsidies are means tested. For example, in Vologda Oblast (as in most other regions), households are entitled to partial reimbursement for their district heating bills only if the bills exceed a certain percentage of household income. In the case of public transport, subsidies are provided in the form of discounted tickets to eligible groups, including honored citizens, senior citizens, school children, and families with three or more children. Subnational governments also provide social assistance in the form of cash payments to eligible groups. These include top-ups to the federal childbirth grant and child allowances, as well as payments to 'labor heroes'. Some of these are means tested or capped, while others (including payments to labor heroes) are not.

**11. Transport (under the budgetary rubric of 'national economy') accounts for 20 percent of subnational expenditure.** Much of this consists of spending on roads, which is financed from earmarked regional road funds. Subnational governments are also responsible for public transport, including the metros of Moscow and St. Petersburg. It is reported that tariffs are generally high enough to cover the operating costs of these systems (although as noted above, certain groups of passengers receive discounted tickets at the expense of their subnational governments). The costs of these subsidies are classified in subnational budgets as social protection rather than as transport.

**12. Housing and communal services: Russia's housing stock has largely been privatized.** Owners of flats in apartment blocks are required to either join homeowners' associations or make other arrangements for the operation and maintenance of

building exteriors and common facilities, including elevators. As a result, subnational government spending on the construction and maintenance of housing for the population at large is limited. Spending in this sector instead consists of three major subcategories.

**13. The first subcategory is capital subsidies to municipal utilities.** In Russia, services such as water supply, sewerage, and district heating are typically provided by municipal unitary enterprises (MUEs). These are owned by city governments and are subject to oversight by municipal departments for housing and communal services. In the main, these enterprises raise sufficient revenues from tariffs to cover their operating costs.<sup>5</sup> (As noted earlier, subnational governments do provide indirect subsidies to these enterprises in the form of subsidies to certain groups, but these expenditures are classified under social protection rather than housing and communal services). However, tariff revenues are reportedly not sufficient to cover the costs of major capital investments such as network extensions into unserved areas and the replacement and upgrading of equipment (e.g., new boilers for district heating plants). These investments are instead financed from the general revenues of city governments, along with grants from the federal government.

**14. The second subcategory consists of spending on the construction of apartments for (or subsidies to) particular categories of citizens such as families with children and teachers in rural areas, along with fuel subsidies to low-income households and grants to municipalities for similar purposes.** The third subcategory consists of spending on ‘beautification’ (e.g., maintenance of parks and gardens). Together, these three subsectors accounted for 35 percent, 32 percent, and 25 percent of total spending in the sector, respectively. ‘Other issues’ accounted for the remainder of spending.

**15. Taken together, these five sectors—education, social protection, health, transport, and housing—account for 85 percent of total subnational expenditure (in 2015).** As shown earlier in Figure 1, the remainder is largely accounted for by administration (6 percent), culture (3 percent), and sports (2 percent). Debt service, treated as a separate sector, accounts for only 1 percent of subnational expenditures.

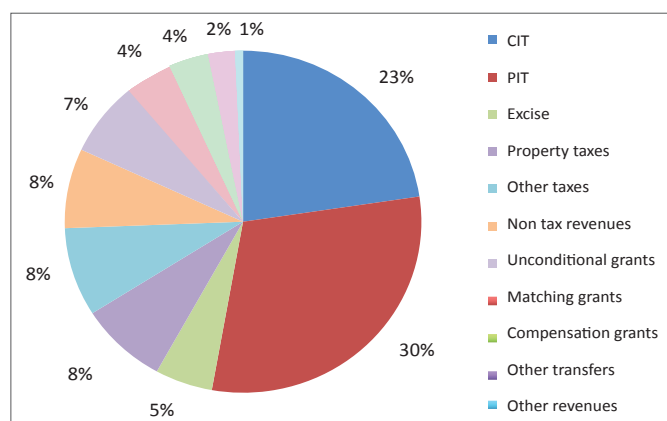
## FINANCING

**16. The general budgets of all three tiers of subnational government (regional, and first and second-tier municipal governments) are financed from a combination of shared taxes, exclusive local taxes, non-tax own revenues, and intergovernmental transfers.** All taxes are administered by the federal tax service with revenues returned in whole or in part to the jurisdiction in which they were collected. Table 1 below lists the taxes assigned to each subnational tier, along with the share of each tax that each tier is allowed to retain.

### Taxes

**17. Shared taxes are the largest source of subnational government revenue.** Two of them—the personal income tax (PIT) and the corporate income tax (CIT)—account for over half (53 percent) of total subnational revenues (in 2015) (Figure 2).

**FIGURE 2: Composition of subnational revenues**



Source: Federal Treasury of the RF.

<sup>5</sup> This has not always been the case; In the 1990s, tariffs were set far below levels sufficient to cover operating costs, but since 1997, the federal government has set national norms for the percentage of total costs of communal services to be recovered from household bills. According to the World Bank’s 2006 infrastructure report, the norm was gradually raised from 35 percent in 1997 to 100 percent in 2005.

**18. Personal Income Tax (PIT):** The PIT is the largest single source of subnational revenue, accounting for 30 percent of the total in 2015. PIT revenues are the exclusive purview of subnational governments—the federal government retains none of it. Proceeds of the PIT are divided among the regional and subregional (first and second-tier) municipalities on the basis of percentages. At present, regional governments retain 85 percent of the personal income taxes (PIT) collected in their jurisdictions. Cities (of oblast subordination) retain the remaining 15 percent (See Table 1). In areas of raion jurisdiction, PIT revenues are divided between the raion government and second-tier municipalities. In urban settlements, *raions* retain 5 percent of PIT generated in those jurisdictions, with the settlement retaining the remaining 10 percent. In rural settlements, *raions* retain 13 percent, with the settlement retaining only 2 percent.<sup>6</sup>

**19. Corporate Income Tax (CIT):** The CIT accounts for 23 percent of total subnational revenues. At present, regional governments retain 90 percent of the CIT, with the federal government retaining the remainder.<sup>7</sup> (Prior to 2009, the regional governments' share had been 73 percent.) Until recently, proceeds of the CIT were retained in the jurisdiction in which they were collected. As a consequence, a disproportionate share of the CIT was retained by the City of Moscow, where corporate headquarters tended to be located. At present, corporate income taxes paid by vertically integrated companies with operations in more than one region are distributed among the regions where the company does business according to the value of the company's assets and employees' salaries in each region. This has resulted in a reduction in Moscow's share of the CIT and a corresponding increase in the shares of other regional governments. Even so, CIT revenues are still concentrated in Moscow. With 8 percent of Russia's population, the City of Moscow accounts for 24 percent of total subnational CIT revenues.

**20. Regional governments are allowed to adjust the rate of the CIT within a range of 13.5 to 18 percent<sup>8</sup>** (they have no control over the rate of the PIT). Tax reductions can be targeted at specific firms. Vologda Oblast, for example, recently provided a five-year reduction in the CIT rate (to the minimum 13.5 percent) to a new fertilizer plant.

**21. Property taxes: Another eight percent of subnational revenues are derived from various forms of property tax.** By far the largest form of property tax, accounting for 77 percent of the total in 2015, is the corporate asset tax (Налог на имущество организаций). This is imposed on movable and immovable property owned by registered companies. Methods of assessment are currently under reform. Previously, the tax was assessed on the basis of book value. With the encouragement of the federal government, regions are now gradually introducing 'cadastral' (market) values for particular groups of taxpayers. St. Petersburg and Vologda Oblast claim that they are now valuing certain categories of corporate property according to its 'cadastral' value. (In Vologda, it is only office and commercial space that is valued at market rates, not factories.) The most recent Russia-wide cadastral valuation was performed in 2012 and used a complex (50 variable) form of mass appraisal. The next cadastral valuation is scheduled for 2018.<sup>9</sup> Regional governments have the authority to set the rate of the corporate asset tax within a range fixed by federal legislation. In Vologda, the rate is 2.2 percent (if assessed at book value) and 2 percent (if assessed on the basis of cadastral value). Small firms were formerly exempt, but are now subject to a rate of 0.5 percent.

<sup>6</sup> The percentage of the PIT retained at the regional level has varied over the years. Prior to 2009, the tax was imposed at a rate of 24 percent, with the regions retaining 73 percent of the proceeds and the federal government retaining the remainder. In 2009, the aggregate tax rate was dropped to 20 percent and the regional share was increased (slightly) to 75 percent. As shown in Table 1, the regional share is now 85 percent, with first-tier and second-tier municipalities retaining the remainder.

<sup>7</sup> In 2017 - 2020, regional governments will retain 85 percent of CIT, with federal government retaining the remainder.

<sup>8</sup> In 2017 - 2020, the range will be 12.5 to 17 percent.

<sup>9</sup> The cadastral evaluation is performed by independent companies authorized by the federal government, and the methodology is unified across the country. The regions can only check if the data on the entry is correct.

### BOX 3: SHARING THE CORPORATE INCOME TAX

Russia is unusual in sharing such a large proportion of CIT with subnational governments—and sharing it on the basis of origin. Most countries in the region only share the PIT. While some (such as Germany) share the VAT, sharing is not on the basis of origin, but rather on the basis of population and other factors.

The most obvious argument against sharing the CIT on the basis of origin is that CIT revenues tend to be concentrated in a few large cities where most companies are registered. As a result, the CIT does not provide much revenue to other places. But there is a more fundamental drawback: As a general principle, the taxpayers of one jurisdiction should not be allowed to impose the costs of the services they consume on taxpayers who live elsewhere. CIT sharing allows them to do so. Although CIT revenues are collected from companies, the ultimate burden of the tax is shifted—backward onto stockholders or labor, or forward onto consumers. There is no reason to believe that these stockholders, workers, or consumers are located in the jurisdiction where the company is registered. As a result, sharing the CIT on the basis of origin allows the residents of places where companies tend to be registered (e.g., Moscow and St. Petersburg) to extract implicit subsidies from residents of other jurisdictions. The current arrangement, in which CIT revenues are partly distributed on the basis of the location of company assets and labor, goes some way to addressing this, but not entirely.

One solution to this problem would be to entirely abolish CIT sharing on the basis of origin. Instead, the subnational share of CIT revenues could be folded into the pool of resources used to finance the equalization transfer. In this way, the equalization transfer would aim to reduce per capita disparities only in the PIT.

#### 22. There are two other forms of property of exemptions and rate reductions for certain classes taxation.

The first is on land. This tax is imposed on both urban and rural plots of land (except forests). Since 2014, land has been valued on the basis of its cadastral value. Proceeds are retained at the municipal level, and municipal governments (including the cities of Moscow, St. Petersburg, and Sevastopol) are permitted to set the rate of the tax, subject to a ceiling of 0.3 percent on agricultural and residential property and 1.5 percent for land in other uses. The land tax accounts for 20 percent of property tax revenues, although only 2 percent of total subnational revenues.

23. The second is a tax on buildings. This is imposed on residential and commercial property owned by individuals (as opposed to corporations). Since 2014, the tax has been assessed on the basis of cadastral values<sup>10</sup> and is retained at the municipal level. Municipal governments are permitted to set the rate of the tax, subject to federal ceilings. The

maximum rate of residential properties is extremely low: 0.1 percent.<sup>11</sup> Federal law also permits a long list of exemptions and rate reductions for certain classes of taxpayers (e.g., pensioners and veterans) and types of property. As a result, the building tax accounts for only 3 percent of property tax revenues and only 0.3 percent of total subnational revenues.

#### 24. Then there are the subnational shares of certain excise taxes—on alcohol and gasoline.

Taken together (with other excises), these account for 5 percent of total subnational revenues. As shown in Table 1, revenues from the excise on alcohol is divided 50:50 between the federal and regional governments, with the regional share allocated on the basis of origin. Eighty-eight percent of the excise tax on gasoline is retained by regional governments. Gasoline tax revenues are distributed among regions on the basis of road mileage, and regional governments are obliged to share 10 percent of the tax with municipal governments on this basis of road mileage.

<sup>10</sup> How accurate and up-to-date these cadastral values are is subject to some dispute. The valuations in Vologda Oblast were reportedly based on norms developed in the 1970s and 1980s, which have been periodically adjusted to reflect inflation. St. Petersburg and Vologda are both contemplating improvements in their methodology for valuing building for tax purposes. Both jurisdictions also note that there has not been an inventory of taxable properties for several years (since 2013, in the case of Vologda). As a result, recently constructed buildings are not being taxed at all.

<sup>11</sup> This ceiling applies to residential properties that are assessed on the basis of cadastral values. The maximum rate for residential properties valued on the basis of book value is 0.3 percent. Note that the maximum rate for office buildings and shopping centers is considerably higher: 2 percent. All other properties are subject to a maximum ceiling of 0.5 percent.



**TABLE 1: Distribution of principal tax revenues among subnational tiers of government**

	Percent share retained by each tier as of 2016*				
	Federal	Regional	First tier municipalities		Second tier municipalities
			Cities	Raions	
Corporate income tax	10	90			
Personal income tax		85	15	5 or 13 <sup>c</sup>	10/2 <sup>d</sup>
Corporate property (asset) tax		100			
Individual property and land taxes			100		10
Vehicle tax		100			
Gambling tax <sup>b</sup>		100			
Retail trade tax <sup>c</sup>					
Excise on alcohol	50	50			
Excise on hard liquors	60	40			
Excise on low-alcohol drinks		100			
Excise on gasoline <sup>d</sup>	12	88			
Excise on fuel for domestic furnaces		100			
Reservoir use tax	20	80			
Simplified tax on imputed income			100	100	
Simplified tax on small businesses		100			
Single agriculture tax			100	50 or 70 <sup>e</sup>	30
Mineral Resource Extraction Taxes					
-Tax on extraction of common minerals and diamonds		100			
-Tax on extraction of other minerals excluding hydrocarbons <sup>f</sup>	40	60			

**Notes:**

a. Urban second-tier municipalities retain ten percent of the PIT; rural second tier municipalities retain two percent. Raions retain the remainder of the 15 percent share assigned to municipalities in total..

b. Where permitted

c. Only in federal cities

d. Gasoline tax revenues are distributed among regions on the basis of road mileage, not origin.

e. Urban second-tier municipalities retain 50 percent; rural second tier municipalities retain 30 percent. Raions retain the remainder

f. 100% of taxes on extraction of hydrocarbons are retained by the Federal Government

**25. Subnational governments also generate income from a variety of other taxes.** Together, these account for about 8 percent of subnational revenues. The most important of these (accounting for one-third of the total) is the transport tax. This is an annual tax on vehicle ownership, based on the power of the vehicle. Subnational governments also retain the proceeds of taxes on small-scale economic activity: the simplified tax on small businesses (which is currently entirely retained at the regional level), the simplified tax on imputed income (entirely retained by the first-tier municipalities), and the single agricultural tax, which is divided among first-tier and second-tier municipalities as shown in Table 1. (This list of excise taxes is not exhaustive).

**26. Regions are also entitled to revenues from certain mineral resource extraction taxes, namely the tax on the extraction the tax on the extraction**

**of common minerals and the tax on ‘other minerals excluding hydrocarbons’.** The former is fully retained by the regions, while the revenues from the latter are shared between the regions (60 percent) and the federal government (the remainder). These taxes are not major revenue sources from an aggregate standpoint but are important in certain regions such as Sakha-Yakutia, a diamond-producing region. In addition, the three federal cities are permitted to impose a tax on retail trade. To date, the tax has only been imposed in Moscow.

**27. Non-tax own-source revenues are non-trivial.** As shown in Figure 2 above, they account for about 8 percent of total revenues. According to the budget code, non-tax revenues include revenues from the sale or lease of property owned by subnational governments (including property owned by their enterprises), revenues from services rendered by

#### BOX 4: RUSSIA'S EQUALIZATION TRANSFER: GOOD PRACTICE?

In most respects, Russia's current equalization transfer represents good practice. It has a logical target (bringing the per capita discretionary revenues of all regions up to a uniform percentage of the national average) and is based on objective, readily measurable variables. The general design of the formula for determining the level and distribution of the transfer is fixed in law and is therefore stable and relatively invulnerable to short term political pressures.

The system does, however, have its critics. Some would argue that it is too complex, given the variety of adjustment factors and the two-stage process for calculating the amount due to each region. Others would say that it places too much of the risk of economic fluctuations on the federal government (as noted in the main text, the transfer represents an open-ended commitment by the federal government to bring the per capita revenues of each regional government up to the target level, regardless of the amount required). Some would say it is insufficiently equalizing, noting the wide variation in per capita revenues that remains even after the transfer is distributed.

But these characteristics represent policy choices; tradeoffs between equally desirable objectives. The complexity of the transfer formula represents an effort to reflect variations in the unit costs of services among regions. The open-ended nature of the federal commitment reduces regional governments' vulnerability to economic turbulence. The existing degree of equalization also represents a tradeoff. On one hand, it can be argued that regional taxpayers should be the ones who benefit from the taxes they pay; e.g., that the taxes paid by the people of Moscow should remain with the Moscow City Government. On the other hand, it can be argued that many of the services provided by subnational governments have implications that extend far beyond the boundaries of a single jurisdiction. One would not want the quality of education in a poor and remote region to depend solely on the strength of its tax base. In evaluating a transfer system, the relevant question is whether it strikes the right balance between these competing objectives.

budget-financed institutions, and fines and fees. Interviews with Moscow City and Vologda Oblast suggest that the majority of revenues under this rubric are derived from the rent or sale of property owned by the respective jurisdictions.

#### Transfers

**28. Transfers from the federal government (i.e., money distributed to regional governments on a basis other than origin) accounted for 17 percent of regional revenues in 2015.** The Russian budget code distinguishes three types of transfers: *dotacii*, *subsidii*, and *subventsii*.

**29. *Dotacii*: Transfers that are not earmarked—i.e., those that can be spent at the discretion of the recipient—are referred to as *dotacii*.** As shown in Table 2, *dotacii* account for 40 percent of total transfers. The largest *dotacii*—and the largest single transfer from the federal government to the regional tier of

government—is an equalization grant. This grant is designed to raise the per capita budget revenues of poorer regions (those with per capita revenues below the national average) up to a target percentage of the national average. In calculating the equalization target, the 10 richest and 10 poorest regions are excluded. Adjustments are also made to reflect variations in the strength of tax bases among different regions, as well as differences in factors that affect the costs of providing services (for example, labor costs, living costs, and population density). The total amount of the transfer is determined endogenously; i.e., the federal government is required to contribute whatever sum is needed to achieve the equalization target. Roughly three-quarters of the regions receive equalization grants.<sup>12</sup>

<sup>12</sup> Starting in 2016, the transfer allocation rules guarantee that regions whose revenues from the equalization transfer are at least 10 percent greater than their other revenues shall receive no less than 90% of the previous year's amount.

**30. In 2015, equalization grants accounted for about 75 percent of total *dotacii*.** Of the remainder, about 20 percent consisted of federal transfers to support increases in the salaries of teachers, doctors, and certain other categories of subnational employees.<sup>13</sup> The salary increases were instigated by a presidential directive advising<sup>14</sup> regional governments to raise the average wages of subnational teachers, doctors, and certain other employees to the average prevailing wage in their respective regions. The directive was issued in 2012, with increases to be phased in over 2013-18. As originally envisioned, the federal government was to pay one-third of the cost of the increase during the transition period, with subnational governments financing the remainder on their own. Officials in a small number of *oblasts* and cities interviewed for this report claim that the targets for specific categories of employees in their respective jurisdictions have been achieved. However, recently, the target has been adjusted downward, by excluding certain higher paid occupations (e.g., police) and including others (e.g., small businesses) from the calculation of the prevailing regional wage.

**31. Other *dotacii* include grants to cities under special regimes: cosmodromes and cities built around scientific centers and defense industries.** The federal government also makes ‘adjustment grants’ under this heading. First introduced in 2004, these grants compensate regions for short-term reductions in tax revenues or increased expenditure burdens that result from federal policies. In 2009, the federal government used this instrument to assist regions whose revenues

were adversely affected by the economic crisis (although the revenue declines were not the direct result of federal policies). More recently, the federal government provided partial compensation to certain jurisdictions for revenue losses arising from the change in the methodology for distributing revenues from the CIT (see above).

**32. *Subsidii* are federal matching grants.** These support a wide range of federal programs, some— but not all—of which involve capital investments. There are reportedly dozens of such programs, many with their own subprograms. (For example, the cattle program has a subprogram for dairy cows and another for beef cattle.) The typical matching arrangement is 14 percent federal/30 percent regional, although this varies. According to interviews in Vologda Oblast, the procedure for applying for these grants and the conditions attached to them are so arduous that many regional governments do not even make the attempt—or at least are very selective in making such attempts.

**33. *Subventsii*: The third major category of transfers consists of compensation for functions that subnational governments perform on behalf of the federal government.** These include unemployment subsidies, rent subsidies granted to certain categories of federal beneficiaries, such as war veterans or victims of radiation catastrophes, benefits paid to blood donors, and the costs of running civil registration offices.

**TABLE 2: Trends in composition of federal transfers**

Transfers	2009	2010	2011	2012	2013	2014	2015
General grants ( <i>dotacii</i> )	39	37	34	32	40	46	40
o/w							
Equalization grants	25	28	24	24	28	26	30
Capital grants ( <i>subsidii</i> )	36	30	31	35	34	25	25
Grants for federal mandates ( <i>subventsii</i> )	19	27	20	18	18	19	21
Other transfers	6	6	14	15	7	10	14

Source: Federal Treasury of the RF.

<sup>13</sup> Although these transfers were intended to achieve a specific purpose, they are nevertheless classified as *dotacii* (unearmarked).

<sup>14</sup> Although subnational governments have the legal authority to set the wages of their employees, federal directives have a strong influence on these decisions.



### Regional variations in per capita revenues

**34. These aggregate figures for Russia as a whole conceal substantial variations across regions—both in terms of levels of aggregate revenues (per capita) and composition.** The table below illustrates the variations in per capita revenues among regions. (Note that the table does not include all regions.) The figure for each region includes the own source revenues of subordinate jurisdictions. Thus, the figure represents the consolidated per capita revenues of all subnational governments in that region, from the regional government itself to the smallest second-tier municipality. Revenues are expressed in thousands of rubles per capita and include both own source revenues and transfers from the federal government.

**35. In essence, the regions fall into three groups.** The first group consists of the eight (generally) sparsely populated oil/gas/gold producing regions located in the far North and East (Siberia) of the country. These are the richest regions in per capita terms, with per capita revenues ranging from Rb 150,000 to 555,000. This is due, in part, to unusually high levels of revenues (per capita) from own source revenues—including the corporate income tax and the personal income tax. In

several cases, it also reflects unusually high revenues from equalization transfers (dotatsii) presumably because the equalization formula recognizes the unusually high costs of providing services in these regions.

**36. The second ‘group’ consists of the cities of Moscow and St. Petersburg, with per capita revenues of Rb 137,000 and 86,000, respectively.** These (again) derive unusually high revenues from own source revenues, including the corporate and personal income taxes. Neither derives significant revenues from federal transfers.

**37. The third group consists of all the other regions, where per capita revenues range from Rb 30,000 (Dagestan) to RB 87, 000 (Murmansk).** As a group, these regions derive about 75 percent of their income from own-source revenues—the corporate income tax, personal income tax, and other taxes and non-tax revenues. Only about 10 percent is derived from equalization transfers.<sup>15</sup> As a result, variations among individual jurisdictions largely reflect variations in their respective tax bases. The correlation between per capita own-source revenues and total revenue per capita is 0.68. Equalization transfers do have some

**TABLE 3: Variations in regional per capita revenues (thousands of rubles)**

Rich natural resource based regions			
88 - Chukotka Autonomous Okrug	555	90 – Yamalo-Nenets Autonomous Okrug	255
61 – Sakhalin oblast	457	38 – Kamchatka Krai	205
84 - Nenets Autonomous Okrug	426		
Moscow, Saint Petersburg			
73 - Moscow	137	St. Petersburg	86
All others			
77 – Altai Republic	79	28 - Vladimir oblast	41
07 – Komi Republic	78	27 – Bryansk oblast	40
19 – Krasnoyarsk Krai	74	63 – Smolensk oblast	40
48 - Moscow oblast	73	52 – Omsk oblast	40
22 – Khabarovsk Krai	68	55 – Penza oblast	36
23 – Amur oblast	64	15 – Chuvash Republic	36
11 – Tatarstan Republic	63	10 - Republic of North Ossetia-Alania	35
78 - Jewish Autonomous Oblast	61	33 – Ivanovo oblast	35
34 – Irkutsk Oblast	53	60 – Saratov oblast	35
80 - Republic of Khakassia	53	04 – Republic of Kabardino-Balkaria	34
14 – Republic of Ingushetia	53	21 – Stavropol Krai	33
57 – Pskov Oblast	41	03 – Republic of Dagestan	30

impact in offsetting variations in per capita own source revenues. Revenues from equalization transfers are negatively correlated with own-source revenues ( $r=-.55$ ). But the scale of equalization transfers is too small to offset variations in own-source revenues. The

regions in the south and west of Russia tend to have higher per capita revenues than those in the north and east. But with few exceptions (such as the Chechen Republic), this is again largely due to variations in regional tax bases.

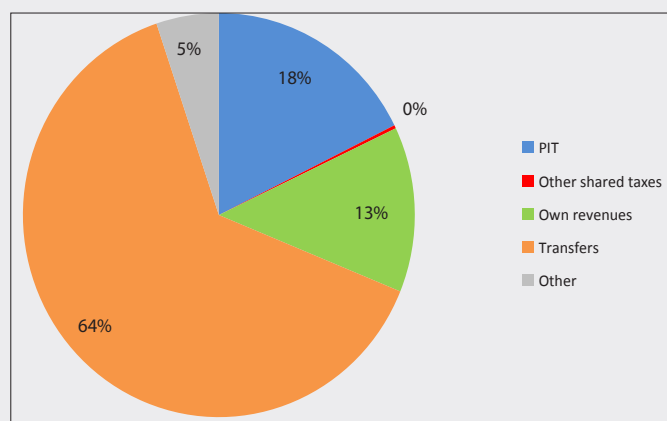
### BOX 5: MUNICIPAL GOVERNMENT REVENUES

Regional governments have considerable discretion over the financing of their municipalities, subject to general guidelines in the Budget Code. The Code authorizes regional governments to use two instruments to provide general budget support (as opposed to earmarked funding for functions such as education) to their municipalities.

First, they may assign a fixed percentage of their own taxes (including their shares of the personal income taxes) to their subordinate jurisdictions. As noted earlier, municipalities are legally entitled to 15 percent of the PIT revenues collected in their jurisdictions. (In the case of jurisdictions with two tiers of municipal government, the upper-tier's share is 5 percent of the PIT in urban jurisdictions and 13 percent in rural jurisdictions.) However, regional governments may increase these percentages on their own cost, provided the shares are uniform for all municipalities and are distributed on the basis of origin.

Second, they may establish formula-based equalization transfers. The Code envisions that these will be allocated on the basis of tax capacity and cost drivers (for example, the socioeconomic status and age profile of the population, climate, and so forth). It also allows for 'negative transfers.' If a municipality's per capita revenues are more than twice the average for the region, the regional government is permitted to take up to 50 percent of the excess and reallocate it to poorer jurisdictions. In their intergovernmental fiscal relations with municipal governments, regions may also combine shared taxing mechanisms and transfers.

**FIGURE B3: Sources of municipal revenues**

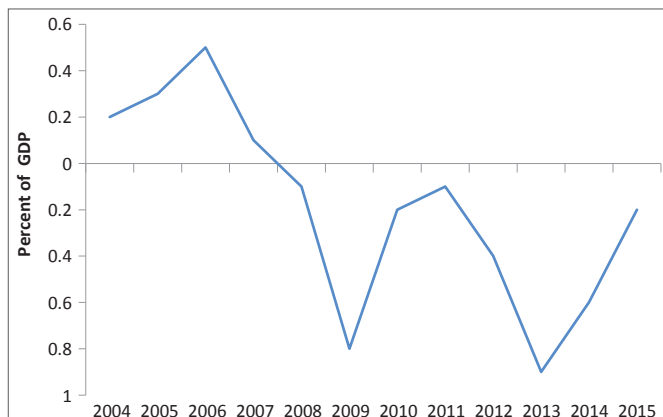


Source: Roskazna.

As shown in the figure above (Figure B3), shared taxes (consisting almost entirely of the PIT) constituted 18 percent of municipal revenues in 2015. Transfers (including equalization transfers and earmarked transfers) constituted 64 percent. As noted earlier, municipalities are also entitled to 100 percent of the revenue from the simplified tax on imputed income, the building tax, the land tax, and the single agricultural tax revenues (municipalities do not administer these taxes but are allowed to set their rates). Together with various non-tax revenues, these account for 13 percent of municipal revenues.

**38. At an aggregate level, subnational governments seem to be weathering the current slowdown in the economy fairly well.** Figure 3 shows the overall balance of consolidated subnational governments as a percent of GDP since 2004. As shown, the aggregate subnational balance reached its nadir in 2013 (at 0.9 percent of GDP), just as the slowdown in the economy as a whole was beginning (Russia's GDP was still growing in 2013, albeit at an anemic 1.3 percent). In 2014, the GDP growth rate shrank to 0.7 percent. As noted earlier, the economy shrank by 3.7 percent in 2015, but the aggregate subnational balance improved over this period, with the deficit declining from 0.6 percent of GDP in 2014 to just 0.2 percent of GDP in 2015. As a percent of revenues, the consolidated subnational deficit declined from 8

**FIGURE 3: Trends in subnational deficits**



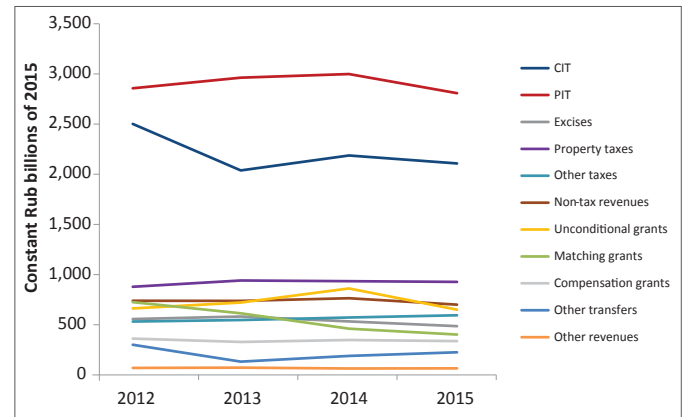
Source: Roskazna.

percent to only 1.8 percent.

**39. How was this possible? It was not due to improvements on the revenue side.** As shown in Figure 4, aggregate subnational revenues declined, in real terms, by 4 percent between 2013 and 2015. While CIT revenues increased modestly (3 percent over their 2013 levels), PIT revenues declined by 5 percent in real terms. In total, subnational tax revenues (including revenues from property, excise and transport taxes) declined 2 percent over the period. Aggregate transfers from the federal government declined even more sharply. *Dotacii* declined by 10 percent, *subsidii* dropped by a remarkable 34 percent,

and only *subventsii* (and the modest category 'other transfers') increased. In aggregate, federal transfers

**FIGURE 4: Trends in subnational revenues**



Source: Roskazna.

declined by 10 percent over the period.<sup>15</sup>

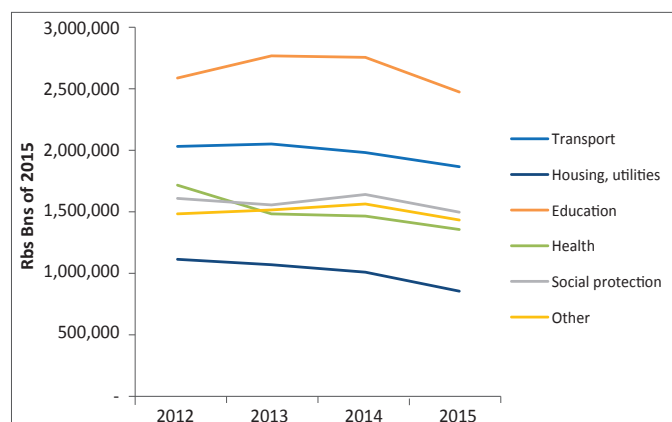
**40. The adjustment instead occurred on the expenditure side.** As a group, subnational governments managed to cut expenditures by 9 percent in real terms between 2013 and 2015—5 percentage points more than the cuts in revenues.

**41. The largest cuts, in absolute terms, were in education.** As shown in Figure 5, total spending on this sector fell 11 percent in real terms between 2013 and 2015 (increasing only 6 percent in nominal terms.) This is somewhat surprising, given the federal directive to increase the salaries of teachers during this period (see above). If subnational governments were struggling to achieve the target before the deadline, this would suggest that education spending would increase rather than decrease over this period. It is not possible to precisely measure trends in the education wage bill over this period. In the Russian budget classification system, subnational spending on teachers' salaries is subsumed in the category 'transfers to municipal institutions'. It is instructive, nevertheless, that spending in this category fell by 7 percent in real terms over the 2013-2015 period, accounting for nearly half of the total decline in spending in the sector. Spending

<sup>15</sup> As discussed below, the decline in transfers was partially offset by an increase in federal transfers to the Federal Medical Insurance Fund (MIF), which allocates these funds to regional MIFs. This enabled a decline in subsidies for health care from regional budgets.

on capital investment also fell dramatically--30 percent in real terms--accounting for another 17 percent of the reduction in total spending. (Cuts in spending on direct labor costs and 'other' account for most of the

**FIGURE 5: Trends in subnational expenditures**



Source: Roskazna.

remainder.)

**42. Cuts in health care were more modest, falling 4 percent in real terms over the period 2013-2015.** As in education, one might expect that the wage bill in regional health care institutions would have risen over this period in response to the federal directive on salaries. Again, one would be stymied by data constraints. As noted earlier, the recurrent costs of the majority of regional health care institutions are largely financed by the national Health Insurance Fund. The majority of subnational spending on health care takes the form of payments to the HIF on behalf of those who are not required to contribute directly and payments to specialized medical institutions that are not covered by the HIF. Data on the wage bill of subnational health care institutions *per se* is not available.

**43. The majority of the cuts fell on facilities that, at the outset, had been directly financed by regional governments.** Subnational health care spending, net of HIF contributions, fell by 23 percent over the period. Capital spending alone fell by 32 percent. But parts of these cuts were offset by an expansion in the scope of facilities covered by the HIF. Over the period, the HIF added maternity wards and emergency rooms to the list, permitting regional governments to reduce

their financial support of such facilities.

**44. The increase in HIF financing was financed by a federally mandated increase in employers' contributions to the HIF.** As employers, regional governments had to increase their contributions as well. Subnational contributions to the HIF increased over this period--by 9 percent in real terms. But overall, regional governments presumably gained more than they lost under the reform. While they were required to increase their contributions to the HIF, they were no longer required to finance the maternity wards and emergency rooms that had formerly been under their purview.

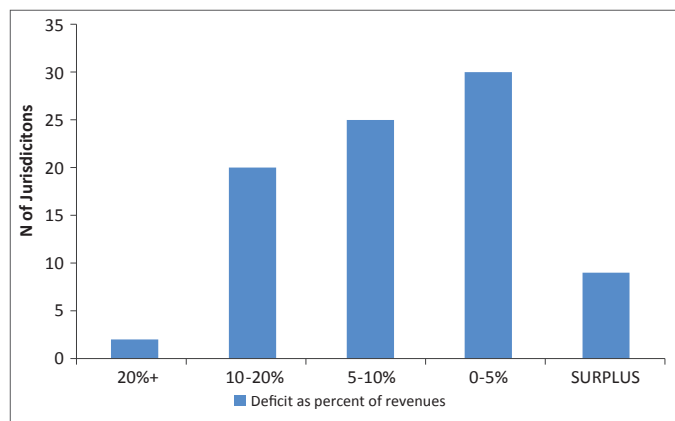
**45. One might expect that spending on social assistance would increase in the face of an economic slowdown, but that was not the case.** Spending on social assistance remained roughly constant over the period. The explanation may lie partly in the nature of social assistance benefits in Russia. As noted earlier, some benefits are not means-tested and are instead allocated on the basis of status; e.g., WWII veterans and labor heroes. Such benefits would not be expected to increase in the face of declining incomes. Other benefits are means-tested but in ways that are more sensitive to changes in policy than actual changes in household income. The level of pension top-ups, as noted earlier, is based on the difference between an individual's federal pension and the official subsistence income for each region. If the official subsistence income is not increased (to account for inflation, for example), the level of the pension top-up would not increase either. It should also be emphasized that regional governments have considerable discretion in designing their own social assistance programs. As long as federal guidelines are satisfied, regional governments may cut benefits to fit their own budget constraints, and they may have responded to the decline in their revenues by doing exactly so.

**46. In addition to the cuts in social spending, subnational governments also made substantial reductions in spending in the infrastructure sectors.** Spending on the 'national economy' sector (largely

roads) fell by 5 percent in real terms. In particular, capital spending (which accounts for about 20 percent of total spending in the sector) fell by 15 percent. Spending in the housing and communal services sector fell even further: 16 percent. Capital spending (which accounts for about 30 percent of spending in the sector), fell by 22 percent. Subsidies to companies, which account for 16 percent of spending, fell by 24 percent. In total, cuts in spending in the infrastructure sectors accounted for 41 percent of the total reductions in spending (in real terms) between 2013 and 2015.

**47. While the aggregate subnational deficit in 2015 was fairly modest (0.2 percent of GDP and 1.8 of consolidated revenues), there are signs of fiscal distress in some jurisdictions.** Figure 6 shows the number of jurisdictions in each of the four deficit-size classes, along with the number of jurisdictions with surpluses. As shown, 30 regions have modest deficits, in the range of 0-5 percent of revenues. Another 25 have deficits in the range of 5-10 percent of revenues. But 22 have deficits of over 10 percent of revenues. Mordovia, Magadanskaya, and Kaliningradskaya top the list, with deficits of 23 percent, 20 percent, and 19 percent, respectively.<sup>16</sup> Only nine jurisdictions had budget surpluses in 2015. These include the republic cities of Moscow, St. Petersburg, and Sevastopol. As a group, the rich oil/gas/gold producing regions tend to outperform the national averages; Four of the seven regions had balanced budgets or small surpluses in 2015, and a fifth had a deficit of only 1 percent of revenues. However, two had substantial deficits,

**FIGURE 6: Subnational deficits**



Source: Roskazna.

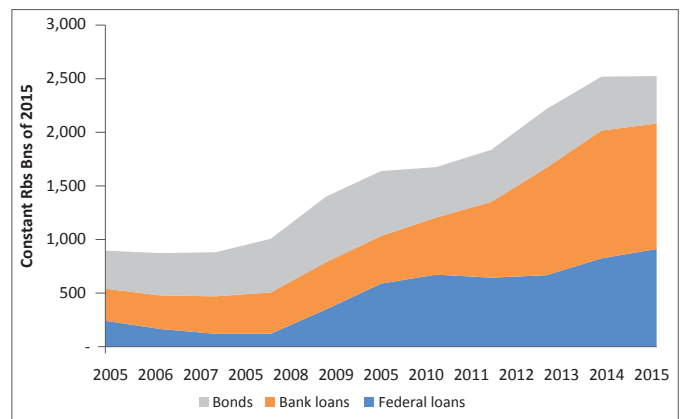
<sup>16</sup> However, these regions do not violate the 15 percent deficit restrictions imposed by the Budget Code because these restrictions do not apply to deficits covered by federal loans.

including the above-mentioned Magadanskaya.

## Debt

**48. Subnational deficits, particularly during the first economic crisis (2009) and the more recent nadir of 2013, have resulted in growing levels of subnational debt.** As shown in Figure 7, the level of subnational debt peaked (in constant terms) in 2014, but has since stabilized. Subnational debt totaled Rb 2,318 billion at the end of 2015. This was equal to 33 percent of subnational discretionary<sup>17</sup> revenues and 2.9 percent

**FIGURE 7: Trends in subnational debt**



Source: Minfin.

of GDP.

**49. While the aggregate level of subnational debt (33 percent) is not large, relative to revenues, some individual regional governments are highly indebted.** Five regional governments have debt-to-revenue ratios in excess of 100 percent. Over half of them have debt-to-revenue ratios in excess of 50 percent. As discussed below, the carrying costs of this debt is generally low, but its short-term nature represents a significant rollover risks in some jurisdictions.

**50. Roughly half of subnational debt (44 percent) takes the form of short-term loans from commercial banks.**<sup>18</sup> Data from the 13 regions, accounting for about 40 percent of total debt (as of January 1, 2016), shows that 45 percent of this debt was due by the end of 2016, 20 percent by the end of 2017, and 20 percent by the end of 2018. Rating agencies consider much of this debt to be speculative. Of the 20 regional

<sup>17</sup> Discretionary revenues are defined as total own-source revenues (including shared taxes) plus unconditional grants.

<sup>18</sup> These banks are not, strictly speaking, private. Commercial bank lending financing of subnational governments is dominated by two state-controlled banks: Sberbank and VTB.

## BOX 6: NON-CONTRACTUAL LIABILITIES

The explicit fiscal difficulties of subnational governments are exacerbated by their implicit liabilities. These liabilities include: (1) public employees' wage arrears, (2) deferred payables to suppliers of utilities to government institutions, (3) deferred payables and debt of regional and municipal public enterprises, and (4) liabilities of joint stock companies in which regional governments possess shares. The scale of these liabilities cannot be determined with the data at hand. Information on these liabilities is not collected and published on a regular basis by the federal government or by the regions. It would be worthy, nevertheless, of further investigation.

governments rated by Fitch since the start of 2016, only four were rated 'marginally good' (BBB). Eleven were in the speculative range (BB- to BB+), and five were rated as highly speculative.<sup>19</sup> The City of Moscow, which was rated in November 2015, was accorded a marginally good (BBB-) ranking.

**52. Commercial banks have been increasingly reluctant to roll over their existing loans to subnational governments, charging high interest rates if they are willing to roll them over at all.** In response, the federal government has stepped in. Following in the tracks of its response to the 2009 fiscal crisis, the federal government is now offering to refinance subnational commercial loans with loans of its own. These loans generally have a maximum maturity of three years.<sup>20</sup>

**53. The current interest rate on them is 0.1 percent, and with inflation running at 13 percent, the rate is strongly negative in real terms.** Federal loans now account for one-third of subnational debt.

**54. Despite the growth in the stock of subnational debt, the cost of servicing debt is not a significant burden to subnational governments.** Interest payments on regional government debt consume, on average, only 1.6 percent of budgetary expenditures.<sup>21</sup> (For municipalities, the figure is only 0.6 percent.) The more pressing problem, at least for some jurisdictions, is the debt's payment structure. Because the majority of commercial debt is short-term, subnational governments continue to face a rollover risk. While the federal government has (so far) been willing to finance the rollover of commercial debt, it is not clear how long this can continue. The government has placed a Rb 310 million cap on the volume of loans it will extend to subnational governments in 2016. Once this ceiling is reached, the federal government may be forced to raise the ceiling or face the prospect of subnational defaults.

<sup>19</sup> The five are: Kostroma, Ryazan, Volgskaya, Mordovia, and Karelia.

<sup>20</sup> The exceptions are federal loans provided for special purposes such as constructing the 2018 Football World Cup infrastructure.

<sup>21</sup> There are exceptions; In Vologda, for example, debt service costs reached 5 percent of total expenditures in 2014.



## BOX 7: DEBT REGULATIONS

If subnational deficits persist, could borrowing get out of control? At present, subnational borrowing is controlled by a tight system of regulations. The current Budget Code sets out the regulations on subnational borrowing. These include three types of debt ceilings.

The first refers to deficits. Budget deficits of regional governments may not exceed 15 percent of annual revenues. For municipalities, the ceiling is 10 percent. In both cases, the calculation of revenues excludes all intergovernmental transfers. In the case of municipalities, it also excludes revenues from shared regional taxes. Even tighter limits are placed on regions that are highly dependent on transfers. For regional governments that derived more than 40 percent of revenues from transfers during two of the three previous years, the deficit may not exceed 10 percent of revenues, excluding intergovernmental transfers. For municipalities that derived more than 50 percent of revenues from transfers, deficits may not exceed 5 percent of revenues (again, excluding transfers and shared regional taxes).

The second ceiling refers to debt stocks. The Budget Code stipulates that the outstanding debt of a region or municipality may not exceed 100 percent of its annual revenues, excluding intergovernmental transfers. For transfer-dependent regions and municipalities, the ceiling is 50 percent.

The third ceiling refers to debt service. The Budget Code stipulates that the debt service of a region or municipality may not exceed 15 percent of expenditures of the relevant year.

Taken together (or even individually), these ceilings would appear to be quite restrictive. By excluding intergovernmental transfers (and shared taxes, in the case of municipalities) from the calculation of revenues, the ceilings severely limit borrowing by jurisdictions that are dependent on these sources. (Technically, a region that depended entirely on transfers would not be able to borrow at all.)

Recent calculations of the debt-to-revenue ratios of each regional government indicate near-universal compliance with the Budget Code ceilings. But the ceilings have one loophole: until 2017, they do not apply to federal refinancing loans. If those loans are included, 18 of Russia's 85 regions would exceed the ceilings; 12 of the regions subject to the 100 percent ceiling and six of the transfer-dependent regions subject to the limit of 50 percent.

**55. While subnational governments have, so far, successfully adjusted to the recent economic downturn, it is not clear how sustainable this adjustment is—whether it can endure in a purely fiscal sense—and what its implications are for the services that subnational governments provide.** The 10 percent (real) cut in spending on education and the 20 percent cut in capital expenditures (across all five major sectors) suggest that Russia is failing to invest in its future. The failure of increasing social assistance spending in the face of falling household incomes suggests that some of the costs of adjustment are falling on the poor.

## SHORT-TERM MEASURES

### Revenues

**56. What can be done? In principle, there are a range of measures on the revenue side that individual jurisdictions could take on their own, within the framework of existing legislation.** To start with, regional governments could raise the CIT rate to the maximum 17 percent and refrain from granting exemptions and tax reductions to individual firms in the future. Given the importance of the CIT, this could have a significant impact on revenues, particularly in the more industrial and urbanized regions. Regional governments could also accelerate the shift from book value to market value as the basis for assessing the company asset tax.

**57. In principle, subnational governments could also increase the yields of other taxes.** They could, for example, accelerate the shift to market values as the basis for assessing the land tax, the building tax (the property tax on physical persons), and the corporate property tax. But the federal ceilings on the rates of these taxes are so low<sup>22</sup> that the fiscal impact of doing so would be very small. As noted earlier, the maximum rate of the land tax (on agricultural land) is only 0.3 percent, and the maximum rate of the building tax (on residential buildings) is only 0.1

percent. Unless the ceilings are raised, neither tax is likely to generate much revenue.

**58. Other countries in the region are often encouraged to increase tariffs on utilities and public transport as a means of generating revenues (or cutting subsidies).** But Russia has already taken advantage of these opportunities. Unlike in Warsaw or Bucharest, for example, tariff levels on the subway systems of Moscow and St. Petersburg are already close to full operating-cost recovery levels. The same is true of district heating companies. While there may be cost-savings measures in both sectors, the opportunity to reduce the fiscal burden that transport and district heating companies impose on the budgets of their owners has apparently already been seized.

**59. In principle, of course, the federal government could help. It could, for example, increase the level of transfers to subnational governments.** This was the federal response to previous crises. But since the federal government now has fiscal problems of its own, this option is unpromising. The federal government could also increase the rate of the personal income tax. As noted earlier, the rate of the PIT is fixed in the federal tax code even though all PIT revenues accrue to subnational governments. That rate is currently a flat 13 percent for most forms of income. Raising taxes in the middle of a recession is a questionable strategy from a macroeconomic perspective, however. The same applies to the other revenue-side measures.

### Expenditures

**60. On the expenditure side, subnational governments could continue to pursue what appears to be their current strategy—cutting capital expenditures and restraining the wage bill.**<sup>23</sup> This is a common adjustment strategy—for both central and local governments—in much of the region. As a short-term measure, it can work well. On the capital spending side, new starts on capital works

<sup>22</sup> The maximum rate on the corporate property tax is a substantial 2 percent. But corporate property is largely assessed on the basis of its book value, which is typically far below market value.

<sup>23</sup> As noted earlier, direct evidence of reductions in the wage bill is not available as subnational expenditures in labor-intensive sectors, such as education, are classified as ‘transfers to municipal institutions’.



can be readily postponed. But suspending ongoing capital works is more problematic, as half-completed works can fall into ruin long before funding becomes available to complete them. Overall, the fiscal impact of cutting capital spending is not likely to be large. This is because capital spending represents only a small proportion of total subnational spending (in Russia, the proportion in 2015 was about 10 percent).

**61. Cutting the wage bill is likely to have a much larger effect, due to the large proportion of subnational spending that is (presumably) devoted to salaries.** In principal, there are two immediate ways to cut wage spending. The first is by freezing nominal wages. This can have a substantial and immediate impact. With the inflation target of 4 percent, which the central bank strives to reach by end 2017, a freeze on current nominal wages would reduce the wage bill by a proportionate percent per year in real terms. This could, of course, run afoul of the federal directive requiring the salaries of certain professions, such as teachers and health workers, to equal the prevailing wage in each region. But if regional wages are also falling, even this obstacle might not exist.<sup>24</sup>

**62. The second technique is to reduce staffing numbers.** Efforts to do so on a large scale can be difficult. In most European countries, confirmed civil service employees are typically protected from dismissal except for cause (public sector unions also play a role in restraining downsizing). A more palatable approach is to freeze new hiring. This can take time to have an impact, however, as net reductions in staff cuts do not occur until existing staff retire. Another approach is voluntary separation—where employees leave in return for financial compensation. But this can be expensive, and employees can also raise problems of adverse selection. Only staff with good prospects of finding alternative employment may take advantage of such programs, and they tend to be the most skilled and hard working employees—the very employees that subnational governments would like to keep.

<sup>24</sup> In the health sector, the direct impact of reducing real salaries would be limited. As noted earlier, regional governments are directly responsible only for financing specialized hospitals. The HIF is responsible for financing the operating costs of all other health care facilities. Cost reductions in those facilities would not directly reduce the premiums that regional governments are required to contribute to the HIF, although the resulting savings could result in a reduction in premiums over the long term.

**63. These strategies are only sustainable in the short-term.** Eventually, capital spending must be resumed to permit the expansion or replacement of infrastructure. Wages have to be increased in order to attract and retain qualified staff, and recruitment must be resumed to fill key positions.

## LONG-TERM MEASURES

**64. In the longer run, fiscal sustainability will require more fundamental changes aimed at improving public sector efficiency.** Experience in other countries suggests several possible targets. At the most general level, regional governments could undertake functional reviews to identify activities that could be dropped or privatized. As described in Box 8, such efforts have shown some success (at least at a national level) in other countries. Regional governments could also pursue reforms in specific functional areas; e.g., capital investment selection, construction contract administration, or procurement reform.

**65. Regions could undertake more targeted methods to restrain their wage bills.** Department-level functional reviews could help identify redundant positions that could be eliminated. Regions might also undertake pay and grading reforms. Such exercises are aimed at adjusting the salaries of individual positions to reflect labor market conditions. It is certainly conceivable that regional governments are paying too much for some positions while paying too little for others. Pay and grading reforms would allow regional governments to increase salaries in occupations that have been difficult to fill while constraining (or even reducing) salaries in occupations where regional governments are now paying more than the labor market requires.

**66. Specific efficiency reforms can be found in individual sectors.** The education sector would appear to be a likely candidate. At a first glance, it appears that substantial savings could be achieved through school network rationalization. As in Eastern European countries, Russia has experienced a decline in the number of school-age children. In principle, this should allow for a reduction in the number of classes and a consequent reduction in the number of teachers. The available evidence suggests that this opportunity has

## BOX 8: FUNCTIONAL REVIEWS: A MIXED TRACK RECORD

Some of the most ambitious efforts to right-size the public sector take the form of functional reviews. The scope of functional reviews varies. Some look broadly at the role of the public sector in order to identify functions that could be abandoned, privatized, or transferred to subordinate levels of government. Functional reviews also vary in terms of the units of government they cover. Some look at the entire public sector, while others look at specific ministries or even specific programs to see how existing functions could be performed more efficiently.

The record of functional reviews is, at best, mixed. Several former socialist countries have used functional reviews to identify government activities that could best be performed by the private sector. This has led to the privatization of a wide range of formerly state-owned commercial and industrial enterprises. But efforts to right-size the residual functions of government—defense and internal security, public education, and health care—have been less successful.

There are cases of ostensible success. One of the most widely cited is the Canadian comprehensive program review of 1994/95. The Canadian effort, launched after years of half-starts and in the midst of a fiscal crisis, required each agency of the federal government to review its own programs to determine which could be offloaded onto the provinces, the private sector, or abandoned altogether, or—if none of the above—performed more efficiently. The Canadian effort reportedly resulted in a 19 percent reduction in the federal workforce (although many positions were merely transferred to the provinces), reduced the number of ministries from 35 to 23, and eliminated 73 government agencies/boards.

New Zealand's functional review, while also focusing on paring down the role of the central government, attempted to increase accountability in the functions that remained. It restructured the government into departments whose functions could be quantitatively measured. Targets were then specified for each department and incorporated in performance agreements, whose results were monitored and, if met, rewarded.

A very extensive set of sector-specific functional reviews has recently been completed in Romania. Eastern Europe has also seen more modest efforts such as the functional review of the Latvian Ministry of Agriculture. This identified and evaluated 161 separate functions within the ministry, of which nine were pegged for privatization, 40 for rationalization, and 12 for transfer to other ministries.

already been seized to some extent. According to the World Bank's recent review of the education sector,<sup>25</sup> a large number of small schools have either been closed or consolidated in recent years, particularly in rural areas where the number of schools has decreased by almost 25 percent. But many of these 'closures' involved only a reclassification of existing schools. They ceased to be independent legal entities and became branches of other schools. In physical terms, they continued to exist. As a result, no cost-savings were achieved. Thus, further opportunities for

network rationalization may exist but will need to be reviewed carefully.

**67. There may also be opportunities for increased cost-savings in the health care sector.** A 2011 report by the European Observatory on Health Systems and Policies<sup>26</sup> found that the Russian health system is significantly biased toward expensive inpatient (hospital) care at the expense of more cost-effective primary care services. According to the report, hospitalization rates are significantly higher in Russia

<sup>25</sup> World Bank, 2012, *The Education System in the Russian Federation*, Education Brief.

<sup>26</sup> European Observatory on Health Systems and Policies, 2011, *Russian Federation Health System Review*.

than in other countries of the WHO European Region. The federal government is reportedly taking steps to close redundant hospitals and expand primary care services.<sup>27</sup> But according to the European Observatory report, there is no evidence yet that this policy has been successful.

**68. Regional governments could reduce spending on social assistance, exercising the discretion granted to them by federal legislation.** A logical strategy would be to improve targeting. As noted earlier, some social assistance benefits are not means tested at all (e.g., benefits to labor heroes). In other cases, targeting is imprecise. The housing allowance, for example, fails to target the poorest of the poor. This is in part because much of it is paid out to households in larger cities (which have higher housing costs) and partly because the amount of the payment is based on the proportion of household income spent on utilities, a highly problematic way to identify the poor. To address this problem, a recent (May 10, 2016) World Bank draft report on social protection<sup>28</sup> recommends mapping and consolidating programs awarded to specific categories of population (e.g., labor heroes) and changing their eligibility criteria so as to focus on individuals/ households with lower incomes. It cites pension top-ups and subsidies for housing and utilities as ‘low-hanging fruit’ for such reforms.

**69. Without such reforms, are subnational governments inexorably heading toward a crisis?** There appear to be two views about this. The subnational government officials interviewed for this report were

remarkably sanguine about the fiscal prospects of their respective jurisdictions. Most of them budgeted for small deficits in 2016 but insisted that this merely reflects their own conservatism rather than any serious expectation of a fiscal shortfall. They intend to muddle through in the hopes that the economy will improve or the federal government will come to their rescue.

**70. Outside experts are more concerned.** Staff at one leading debt rating agency argue that subnational governments have exhausted their budgetary flexibility and have no more room to adjust. In particular, they note that capital spending has been reduced to the bone, that the prospects for increased federal support are poor, and that some jurisdictions are therefore likely to follow Novgorod Oblast into default.

**71. The most plausible scenario probably falls somewhere in between.** It is true that subnational governments have little opportunity to make adjustments on the revenue side. Within existing federal constraints, they have limited ability to increase the yield of the CIT and virtually no opportunity to increase revenues from the PIT. But they do have opportunities to reduce expenditures. This has been their strategy so far. How far they can go without collateral damage is contingent on how they make the cuts: this depends on whether they rely largely on cuts in the real salaries of front-line service providers and capital spending, or whether they focus on measures aimed at improving efficiency of individual services.

<sup>27</sup> According to the State Statistical Service, the number of district hospitals in rural areas fell from 2,631 to only 124 between 2005 and 2013. But at the same time, the number of local health clinics fell from 7,404 to 2,561. As in the case of schools, these closures often represented only a change in legal status: the facilities ceased to be independent legal entities and became branches of other health care facilities. In physical terms, they continued to exist. As a result, no cost-savings were achieved.

<sup>28</sup> Aleksandra Posarac, Zoran Anusic, and Ruslan Yemtsov, May 10, 2016, “Russia SCD: Social Protection”, Draft report.

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