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Working Party of Senior Budget Officials

BUDGETING IN RUSSIA

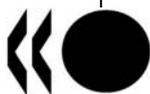
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BUDGETING IN RUSSIA

Preface

This review of the budget procedure of the Russian Federation was carried out as part of the Work Programme of the OECD Working Party of Senior Budget Officials (SBO) to which the network of Senior Budget Officials of Central, Eastern and South-Eastern European countries reports. This network has been established in 2004 at the initiative of the Working Party of Senior Budget Officials. Budget reviews serve as a basis for the examination of the budget procedure during the annual meetings of the network and enable the members of the network to discuss the budget procedure of the country under examination in depth.

A mission consisting of Dr. Dirk-Jan Kraan (head), Mr. Daniel Bergvall, Mr. Ian Hawkesworth, Mrs. Valentina Kostyleva (OECD Secretariat) and Dr. Matthias Witt (German Technical Cooperation) visited Moscow from 1 to 5 October 2007 to carry out the review. During its visit the mission met with Mrs. Tatiana Nesterenko, Deputy Minister of Finance, Mr. Alexey Lavrov, Director of the Budget Policy Department, Mr. Roman Artiukhin, Head of the Federal Treasury, and senior officials of the Ministry of Finance of the Russian Federation, Mr. Dmitry Amunts, Deputy Minister of the Ministry of Culture and Mass Communication, Mr. Vadim Dubinkin, Head of the General Audit Department of the Accounts Chamber of the Russian Federation, Mrs. Vera Kotelnikova, Deputy Head of the Secretariat of the Budget and Tax Committee of the State Duma of the Russian Federation, Mr. Evgeni Bushmin, Chairman of the Budget Committee of the Federation Council of the Russian Federation, Mr. Sergei Drobyshevsky, Head of the Budget Policy Unit, and other senior policy analysts of the Institute of the Economy in Transition, Mrs. Olga Yastrebova, Director, and other senior policy analysts of the of Ecorys-NEI Research and Consulting, Mrs. Elena Lebedinskaya, Senior Policy Analyst of the Economic Expert Group and Mr. Neven Mates, Senior Resident Representative of the International Monetary Fund in Moscow.

OECD Budget reviews are meant to serve as a basis for peer review among budget officials. They can only serve this purpose if they are based on accurate information about the decision-making process and the incentives and constraints that determines its outcomes in each of its stages. This information is not always available in official documents. Nevertheless the mission feels that it has acquired a fair picture of the Russian budget process thanks to the frankness and openness that have characterized the discussions with the Russian officials throughout the mission's visit. The mission would like to express its gratitude and appreciation for the cordial reception by the Russian authorities and for their helpful attitude during the meetings.

The mission would like to thank Mr. Alexey Lavrov, Director of the Budget Policy Department and his collaborators for the excellent organisation of the meetings, their unsparing help with the collection of information and documents, and their hospitality during the mission's stay in Moscow. Finally, the mission would like to thank Sergei Ponomarev (OECD Moscow Office) for his great help with the organisation of the mission and useful advice concerning the conduct of the review.

The views expressed in this report are those of the OECD Secretariat and should not be attributed to any organisation or individual consulted for this review.

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CHAPTER 1 INTRODUCTION

General characteristics

1. Since the economic, monetary and political turbulence of the 1990's the Russian economy has moved into a more stable pattern of development. Thanks to a more steady policy course followed by the fiscal and monetary authorities and the gradual expansion of revenues from oil-production, the economy has grown since 2000 at an average rate of 6.7 percent annually (OECD 2006). Simultaneously the situation of the public finances has considerably improved. The general government surplus was 8.4 percent of GDP in 2006 and 4.9 percent in 2007 (non-oil deficit 4.4 percent of GDP in 2006 and 5.3 percent in 2007).

2. Russia is a federal state. The government is structured in three layers: federal, regional and local. Federal expenditures amounted to 15.9 percent of GDP in 2006 and 17.5 percent in 2007. At the regional level there are six types of governments. The names and distinctions have a historical background and little actual significance. The geographical size and population of the regional governments varies considerably. The average population is 1.7 million. Regional expenditures amounted to 11.3 percent of GDP in 2006. At the local level the government structure is complex because of the variety of bodies. Basically there are two sub-layers at the local level: upper level municipalities (mostly municipal districts) and lower level municipalities (urban and rural settlements). Municipal expenditures amounted to 5.6 percent of GDP in 2006¹. Both regions and municipalities receive a significant share of their revenues from federal grants.

3. There are three federal Extra-Budgetary Funds in Russia. The budgets of these funds are presented to Parliament along with the federal budget. Decision-making is fully coordinated with the regular budget process. The funds are: the Pension Fund the Social Insurance Fund, and the Mandatory Health Insurance Fund. All three are social security funds. The revenues mostly come from earmarked taxes. Total expenditures of the funds amounted to 6.9 percent of GDP in 2006 and 7 percent of GDP in 2007. At the regional level there are the Territorial Mandatory Health Insurance Funds. The regional budgets of these funds are closely coordinated with the regional budgets in a similar way as the federal funds and budget are. Federal and regional extra-budgetary funds receive a significant share of their revenues from federal respectively regional transfers.

4. Table 1 shows an overall picture of the expenditure and revenue flows in the Russian government sector.

¹ Data for 2007 not yet available.

Table 1. Expenditure and revenue flows in the Russian government sector, 2006
(% of GDP)

	Total revenues	of which transfers from other budgets	Total expenditures	of which transfers to other budgets	Balance (+ is surplus)
General government	39.6	0.0	31.2	0.0	8.4
Federal government	23.3	0.1	15.9	5.6	7.4
Federal Extra-Budgetary Funds	7.0	3.5	6.9	0.4	0.1
<i>of which</i>					
State Pension Fund*	6.1	3.1	5.7	0.0	0.4
Social Insurance Fund*	0.8	0.1	0.8	0.0	0.0
Federal Mandatory Health Insurance Fund *	0.5	0.3	0.4	0.4	0.0
Regional government **	11.8	2.3	11.3	3.2	0.5
Local government **	5.7	3.3	5.6	0.3	0.0
Territorial Mandatory Health Insurance Funds*	1.3	0.4	1.3	0.0	0.0

* Data for separate extra-budgetary funds were obtained from the Russian statistical agency (Rosstat) and are not completely consistent with Treasury data.

** Data for regional and local government were obtained from the Ministry of Finance and are not completely compatible with Treasury data.

Sources: Rosstat (2007), Treasury financial reports 2006.

5. In recent years the Russian economy has become more integrated with the rest of the world. Exports have increased at an average annual rate of 7.4 percent from \$ 101.9 billion² in 2001 (of which \$ 52.2 billion oil and gas) to \$ 303.9 billion in 2006 (of which \$ 190.8 billion oil and gas). Import volumes have increased at an average annual rate of 20.5 percent in the same period from \$ 53.8 billion in 2001 to \$ 164.7 billion in 2006 (IMF 2006b and IMF 2007). The Russian authorities hope to complete accession to the World Trade Organization by early 2008. Russia is a long standing member of the IMF. In May 2007 the Council of the OECD has recognized Russia as a candidate member and opened negotiations aimed at accession.

6. Russia is the largest country in the world in terms of surface, stretching from Eastern Europe to the Pacific Ocean. It has a population of 142.8 million (2006). From an economic point of view there is a considerable demographic problem in that the total population is decreasing, on average 0.4 percent annually or by some 6 million over the period 1995-2005 (OECD 2006), notwithstanding a substantial immigration mainly from countries belonging to the Commonwealth of Independent States (CIS, countries belonging to the former Soviet Union). At present (2007), the total birth ratio stands at 10.6 per 1.000, one of the lowest in Europe, the fertility ratio³ at 1.43 (Ministry of Finance of the Russian

² \$ is US Dollar.

³ Average number of children per woman.

Federation 2007). Immigration surged from average 130,000 annually over the period 1985-1992 to a peak of 810,000 in 1994 and declined since then to 128,000 in 2006 (IMF 2006c).

7. Since the dissolution of the Soviet Union in 1991 the Russian Federation is a federal republic with a presidential system of government. The constitutional changes of the 1990's have led to a thorough modernization of the legal framework of the republic. The President is elected directly by the population through universal suffrage. The Parliament consists of two Chambers, the State Duma and the Council of the Federation. The Duma has 450 members and is elected directly by universal suffrage. The Council of the Federation is elected by the 85 "constituent territories of the Federation" (the regions). The President appoints the Prime Minister and the Ministers. According to the Constitution (art. 117), the Council of Ministers, further to be called the (Federal) Government, needs the confidence of the State Duma, but due to the large majority of United Russia since 2000, it has not yet occurred that the Government or ministers have been forced to resign. The Constitution contains guarantees for the independence of the judiciary branch of government. Similarly, the independence of the Court of Accounts is guaranteed by the Constitution.

8. Of the employed working population of 66.9 million persons (2005), 10.8 percent (about 7.2 million) worked in agriculture, hunting forestry and fishing, 21.8 percent (about 14.6 million) in industry and 48,6 percent (about 40.0 million) in services, of which 21.4 percentage points (14.1 million) in public administration, defense, education, health care and social work. Unemployment was estimated by the ILO at 7.6 percent of the working population (2005, based on employment surveys). Registered unemployment stood at 1.8 percent of the working population which 1.5 percent points received unemployment benefits. These numbers make clear that Russia is an industrialized country with a still large agricultural sector, an already well developed services sector, a moderately sized government sector⁴ and still sizeable unemployment⁵.

9. Russia has still a long way to go in order to reach a level of prosperity that is comparable with that of OECD countries. In purchasing-power parity terms Russia's per capita GDP was about 37% of the OECD average in 2005 (OECD 2006). A disparity of this magnitude is characteristic for many Eastern European countries. It implies that convergence with the Western-European level of prosperity will only occur over the next 30 years, if these economies succeed in growing at a pace that is annually 3 à 4 percent higher than that in the OECD area. Russia has an advantage in this respect over other countries in the region by its wealth of natural resources, in particular hydrocarbons (oil and gas) and metals. On the other hand this advantage also poses a particular challenge in that it leads to a permanent external trade surplus and appreciation of the currency. Furthermore, over the last few years rising oil and gas exports have been accompanied by a huge improvement in the terms of trade that have occurred since the beginning of century as a consequence of the surging oil price⁶. This may threaten the competitiveness of the Russian

⁴ Public enterprises (a large sector in Russia) are not included in the government sector. Contrary to widespread belief, in terms of employment the government sector is not particularly large in Russia (on this point see also OECD 2006 chapter 3).

⁵ For instance the numbers for France, the UK and Spain are the following: France: 1.5 percent agriculture etc., 23.2 percent industry, 61.6 percent services of which 27.4 percent public administration etc.; the UK: 0.7 percent agriculture etc., 21.1 industry, 66 percent services of which 30.7 public administration etc.; Spain: 3.2 agriculture etc., 30.9 industry, 51.8 percent services of which 20.8 public administration, etc (IMF 2006b, OECD.Stat, ILO database).

⁶ The enormous increase in revenues from oil production (more than 200 percent over the period 2000-2005) is largely due to the price increases and taxation and to a much smaller extent to increased output (about 60

industrial and services sectors in tradable goods and services in both foreign and domestic markets and could lead to the syndrome of “Dutch disease” if handled in the wrong manner⁷. So far Russia has largely resisted the inclination to spend too much of its oil and gas wealth on imports, but the major challenge that still lies ahead is the development of its own productive capacity.

10. According to international assessments, the Russian economy is presently close to full employment of the existing stock of capital and labour (OECD 2006, IMF 2006a, IMF 2007). Furthermore, due to flexible labour law, enterprises have been able to fire and hire relatively easily, resulting in an efficient reallocation of production factors. Consequently, the opportunity for further “cheap” growth by raising total factor productivity is reaching its limits. This implies that the future growth of the Russian economy has to come from investment, both in the market and the public sector. But in these respects, Russia has been lagging behind many Eastern European countries in comparable stages of transition such as the Baltic countries, Hungary, Poland and the Czech Republic (in Russia average annual gross fixed capital formation over the period 2000-2005 was 18 percent of GDP whereas in the mentioned countries it was between 20 and 30 percent of GDP; compare also China, where it was 39 percent of GDP; in 2006 Russian gross fixed capital formation stood at 20.2 percent of GDP). The share of foreign direct investment in Russia at around 15 percent in 2006, is also much lower than comparable transition countries⁸.

11. So far, in spite of low investments, economic growth has remained strong in Russia. The main driver of growth is consumption spurred by annual increases of real incomes of more than 10 percent and tax relief. Inflation remains relatively high (9 percent CPI in 2006) reflecting the policy of the Central Bank to control the appreciation of the Rouble through direct intervention in the money markets. The monetary authorities are committed to a gradual reduction of inflation to 6-7 percent in 2008 and a half percent decrease in following years until an acceptable level of 3-4 percent is reached (Ministry of Finance of the Russian Federation 2007), but in 2007 inflation has picked up again and it remains to be seen whether the long term aim remains realistic as long as the Central Bank clings to its policy of controlling the exchange rate.⁹ Consistent with the rapid real appreciation (nominal appreciation plus inflation), growth is concentrated in the non-tradable sectors: retail trade and construction running well above 10 percent real growth. In manufacturing growth is in line with overall growth at about 6-7 percent. Growth in oil production has not recovered from its decline in 2004-2005 when it fell from 12 to 3 percent as a consequence of lack of development of new fields and limited pipe line capacity. Table 2

percent points). Furthermore the increase in oil production has been falling fairly dramatically over the last years (oil production rose just 2.5 percent in 2005 as compared with an average of 8.5 percent annually over the period 2000-2004). Lack of investments and infrastructure constraints have been important factors in bringing about this deceleration. Output in the inefficient gas sector has virtually stagnated since the beginning of the century, whereas revenues from gas have increased with more than 80 percent (OECD 2006).

⁷ “Dutch disease” is the phenomenon that permanent real appreciation of the currency (nominal appreciation plus inflation) induced by commodity exports, impair the competitiveness of domestic production sectors in tradable goods both in foreign and domestic markets. This happened in the Netherlands during the eighties as a consequence of increasing exports of natural gas.

⁸ Investment rates in Russia are also diverging sharply between sectors. In some sectors, such as agriculture, food products, refined petroleum products and nuclear fuel, machinery and equipment, transport equipment, electricity, gas and water supply, and construction, they have been particularly low (less than 10 percent or negative year on year growth in 2005).

⁹ The IMF has been critical of the exchange rate policy of the Central Bank and has advised the Russian monetary authorities over the years to focus on inflation, rather than on the double (and inconsistent) objectives of inflation and exchange rate control (IMF 2005, IMF 2006, IMF 2007).

presents the growth performance of Russia in comparison with the 15 (old) EU countries and the 12 EU (central and eastern European) accession countries. It appears clearly that, despite low investments, Russia is still doing better than the EU countries in Central and Eastern Europe.

Table 2. Growth of real GDP
(percent change on previous year)

	2002	2003	2004	2005	2006	2007	2008
EU15 (old)	1.1	1.2	2.3	1.6	2.8	2.7 ^(f)	2.5 ^(f)
EU10/12 (accession)	4.1	4.3	5.3	5.8	6.2	5.5 ^(f)	5.0 ^(f)
Russia	4.7	7.3	7.2	6.4	6.7	7.0 ^(f)	6.8 ^(f)

(f): forecasts

Source: Eurostat database (for EU 15, EU10/12), IMF World Economic Outlook database (for Russia), OECD calculations (for EU10/12 forecasts).

12. Proceeds from oil production make up a considerable part of the revenues of the Russian federation. These flows accrue to the budget by way of the mineral extraction tax, which is levied on oil extraction at a rate of 22 percent of the excess over 9 USD per barrel (Urals), and the export customs duty on oil, which is levied at a progressive rate of the excess over 15 USD c.i.f.¹⁰ per barrel. Although estimates vary, the combined marginal taxation rate of the mineral extraction tax and the exports customs duty on oil is above 80 percent and the combined average tax rate on oil is above 70 percent (in 2006)¹¹. A part of the oil revenues of the Federal Government is saved in the Oil Stabilization Fund¹².

13. Figure 1 shows the development of expenditures and revenues of federal government. Oil revenues of federal government¹³ are indicated separately. The numbers over the period 2007-2010 are presented in accordance with the budget documents accompanying the budget 2008-2010¹⁴.

¹⁰ Inclusive (transport) costs, insurance and freight.

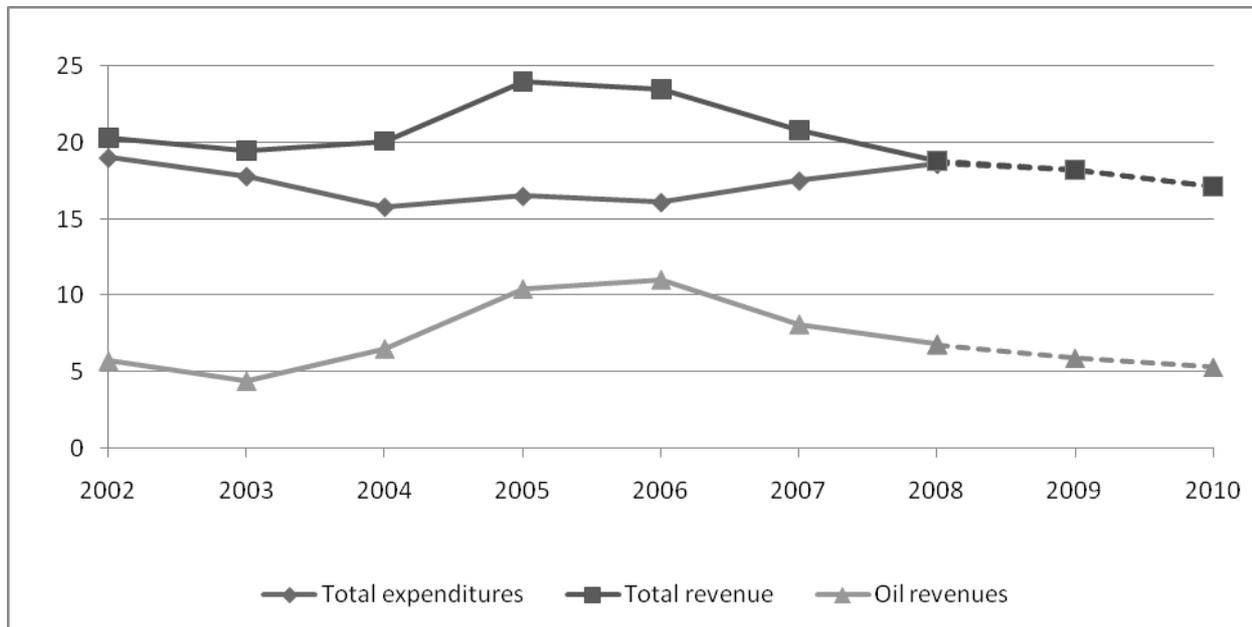
¹¹ OECD (2006).

¹² Namely until 2007: all revenues in excess of the cut-off price, and after 2007: all oil revenues minus the oil transfer (see chapter 2 box 2). In the period between 2004 and 2007 this amounted roughly to a share between one third and a half of federal oil revenues. For 2008 that will be 14.7 percent of the federal oil revenues (on the basis of the very cautious oil price assumptions of the budget).

¹³ Sub-national government also has some oil revenues, mainly through its 5 percent of the mineral extraction tax on hydrocarbons.

¹⁴ The IMF estimates expenditures 1.8 percentage points higher, non-oil revenue 1.1 percentage point higher and oil revenues 1.0 percentage point higher in 2010 (IMF 2007). These differences are mainly due to different assumptions concerning the spending of the unallocated margin in the 2007-2010 budget.

Figure 1. Expenditures and revenues of the Russian Federation
(% of GDP)



Source: Ministry of Finance of the Russian Federation (2007).

14. Since the financial crisis of 1998 when the Rouble lost two thirds of its value, Russia has practiced a prudent fiscal policy. This has contributed to the revival of private investment and persistent high real growth in the subsequent years¹⁵. Since 2000, federal budgets have been based on conservative oil price assumptions. This approach has delivered sizeable surpluses. Moreover it has shielded the economy from price volatility in the oil market. The Government has largely resisted the temptation to spend the oil revenue windfall and instead has used a significant part of it to repay debt and to accumulate reserves. In the years after the crisis there have been deep cuts in expenditures (including all levels of government and social security funds), mostly by reducing salaries and pensions in the public sector. Expenditures in 2003 were about 10 percentage points of GDP lower than before the crisis while revenues relative to GDP were in 2003 at roughly their pre-crisis level. In the period 2005-2007 there has been considerable slippage of fiscal discipline. The federal non-oil deficit was allowed to increase with 2.6 percentage points GDP (in 2007 relative to 2004). In 2006 and 2007 supplementary budgets were approved halfway the year with sizeable new spending plans. Additional spending in this period focused on the areas of healthcare, housing, education, agriculture, infrastructure, the military and the judiciary. Much of this spending was targeted for wage increases which the authorities considered essential to facilitate reforms. In addition transfers to the pension fund were increased to compensate for a substantial cut of the unified social tax and continued compliance problems. The supplementary budget 2007 aimed in particular to boost investment by subsidies to research programmes and to the aluminium, petrochemical and nuclear power sectors. Because of the surging oil prices, the decrease in the overall balance induced by these additional spending programmes have remained modest (1.0 percentage points

¹⁵ In the years 1995-1998 there were large general government deficits which were financed by government bonds with double digit interest rates. This crowded out private investment. From 1990 to 1998 real investment fell continuously (OECD 2004).

of GDP relative to 2004¹⁶). The new three-year budget 2008-2010 supposes considerable restraint in the year 2008 and retrenchment of 2 percentage points GDP in the years 2009-2010. Whether these plans will be realized remains to be seen (IMF 2006, IMF 2007).

15. At the revenue side major reforms in the tax system took place in the period 2000-2004. The most important steps included the introduction of a flat-rate income tax of 13 percent, the introduction of the unified social tax (that finances the social security funds), the elimination of the various sales taxes, the lowering of the rate of the profit tax from 35 to 24 percent in conjunction with the abolition of numerous tax breaks, the introduction of the mineral extraction tax and the lowering of rate of the Value Added Tax from 20 to 18 percent. Except the introduction of the mineral extraction tax, these reforms were generally aimed at broadening the tax base and relief of the tax burden. These reforms were facilitated by the gradual increase of the federal oil revenues.

16. Table 3 shows the resulting federal government and general government balance. The convergence of the primary and overall balance in the period 2002-2006 reflects the rapid repayment of the external public debt. The improving overall balance since 2004, in spite of the deteriorating non-oil balance since 2004, reflects the increasing oil revenues.

Table 3. Budget balance of Federal Government and General Government in Russia
(in percent of GDP)

	2002	2003	2004	2005	2006	2007	2008	2009	2010
Federal government:									
Primary balance	3.4	3.4	5.4	8.4	8.0	3.8 ^(f)	0.7 ^(f)	0.5 ^(f)	0.6 ^(f)
Overall balance	1.3	1.7	4.3	7.5	7.4	3.3 ^(f)	0.2 ^(f)	0.0 ^(f)	0.0 ^(f)
Non-oil overall balance	-4.4	-2.7	-2.2	-2.9	-3.6	-4.8 ^(f)	-6.6 ^(f)	-5.9 ^(f)	-5.3 ^(f)
General government:									
Primary balance	2.7	3.3	6.1	9.1	9.2	5.5 ^(f)	3.3 ^(f)	na	na
Overall balance	0.6	1.4	4.9	8.2	8.4	4.9 ^(f)	2.8 ^(f)	na	na
Non-oil overall balance	-6.9	-4.6	-2.9	-4.6	-4.4	-5.3 ^(f)	-6.6 ^(f)	na	na

na: data not available

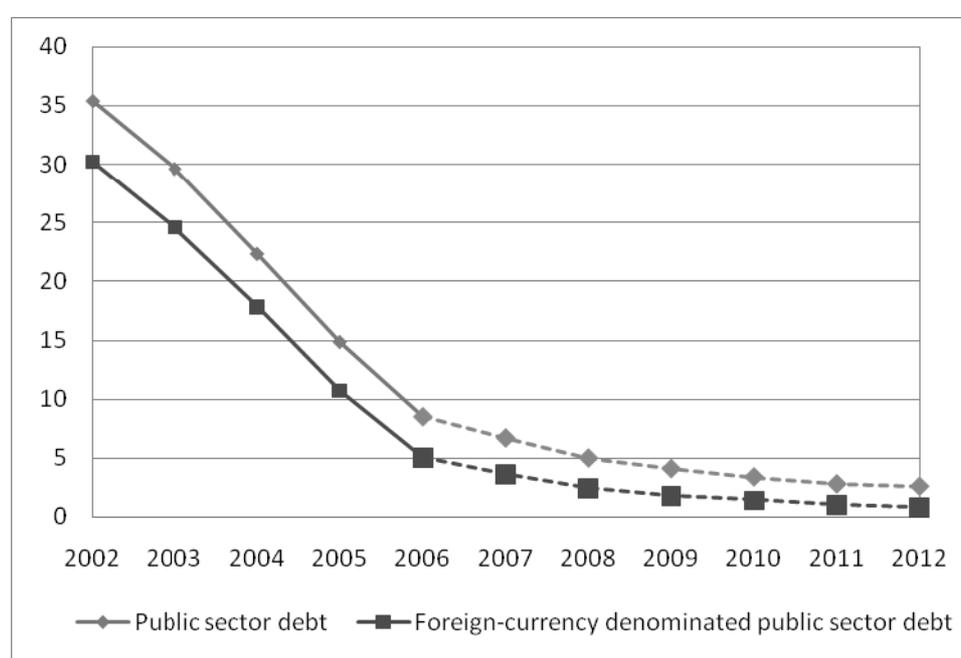
(f): forecasts

Sources: IMF 2006 b (for 2002-2003), IMF 2007 (for 2004-2006 and 2007-2008 General Government) and Ministry of Finance of the Russian Federation 2007 (for 2007-2010 Federal Government).

¹⁶ Oil price upsurges have increased federal oil revenues with 1.6 percentage points GDP over the period 2005-2007 (compared to 2004), so that the real costs of the additional spending programmes were 2.6 percent of GDP.

17. Due to the increasing oil production since 2000¹⁷ and surging oil prices in the period since 2003, oil revenues have risen steadily. The Oil Stabilization Fund, established in 2004 had reached its statutory minimum size of 500 billion RUB at the beginning of 2005. Subsequently, its size has risen to about 4700 billion RUB at the end of 2006. According to the Budget Code sums in excess of 500 billion RUB may be spent on unspecified “other purposes” with the consent of Parliament (such spending must be specified in the annual budget law). Hitherto the Government has mainly used these surplus revenues for early repayment of foreign debt. In particular 23 billion USD was repaid in 2005, mainly to the Paris Club of creditor countries and another tranche of 33 billion USD was repaid in 2006. Since domestic debt has been relatively small since the late nineties, public debt has fallen to insignificant levels in Russia. Figure 2 portrays this development.

Figure 2. Public debt of the Russian Federation
(in percent of GDP)



Source: IMF (2007)

Institutional policy in the recent past

18. Since the beginning of the century Russia has thoroughly reformed its budget procedure. Important stages in this reform effort were the adoption of the Budget Code in 1998 and major revisions of the Code in 2003, 2004 and 2007. In parallel international organisations have regularly assessed the Russian budget institutions and have formulated recommendations. The reforms were largely in accordance with the recommendations but sometimes not. This section will briefly review the most important of these reforms and recommendations.

19. The Budget Code of the Russian Federation was adopted in July 1998, shortly before the financial crisis, and entered into force in 2000, shortly after the crisis. The Code put the budget process in Russia

¹⁷ Oil exports have increased slightly less than 50 percent over the period 2000-2005. Oil prices have increased about 90 percent over the same period.

on a modern footing. It sets out the contents of the annual budget laws, defines the jurisdictions of federal and regional government and regulates their financial relations, prescribes the annual budget preparation and execution time schedule and lays down rules for the public debt. Moreover it introduced a Single Treasury Account, held at the Treasury, and forbade all cash holdings in domestic currency by government agencies outside this account. This meant a first important step on the long road to the abolition of extra-budgetary spending in Russia. The Code explicitly embraces the principle of openness and mandates the publication of the draft budget law and budget execution reports and prescribes an extensive set of documents that must accompany the budget bill, when it is submitted to Parliament.

20. Major revisions of the Budget Code were enacted in 2003 and 2004. The revision of 2003 created the Oil Stabilization Fund. The revision of 2004 led to a reform of the fiscal relations with the regions and prescribed fiscal rules for sub-national government.

21. The Oil Stabilization Fund was established in 2004, following the amendment of the Budget Code of 2003. The statutory purpose of the fund was to insure the federal budget against oil-price volatility. Revenues from the mineral extraction tax (95 percent¹⁸) and the export customs duty on oil (100 percent) in excess of the cut-off price of the Oil Stabilization Fund, were flowing into the Fund. The cut-off price was first set at 20 USD per barrel (Urals) and raised to 27 USD per barrel (Urals) in 2007. By law the resources of the Oil Stabilization Fund could be used to finance the federal budget deficit when the oil price was below the cut-off price. If the accumulated resources had reached 500 billion RUB (about 2 percent of GDP), the resources of the fund could be used for certain other purposes, such as the repayment of foreign debt¹⁹. As a temporary measure resources from the Fund have also been used in 2005 to finance the gap in the pension fund that emerged due to a cut in the unified social tax. The Fund is managed by the Ministry of Finance. The only assets in which the reserves of the Fund may be held are foreign government securities of states listed by the Government.

22. In addition to its budgetary role, the Oil Stabilization Fund fulfils an important role in monetary policy. In view of the objective of the monetary authorities to slowdown the appreciation of the Rouble driven by the increasing oil exports and the increasing oil-price, the Central Bank intervenes on a large scale in the money market²⁰. According to IMF estimates annual broad money growth (inclusive foreign assets) reached 48 percent (year on year) in April 2007. The task of sterilization of the resulting money creation, falls mainly to fiscal policy and in particular the Oil Stabilization Fund²¹. According to OECD estimates over the period from January 2004 to July 2006 about half of the net increase in foreign assets was sterilized through general government deposits (mainly by the Oil Stabilization Fund) at the Central

¹⁸ That is 100 percent of the federal share of this tax, the remaining share of 5 percent is going to the regions.

¹⁹ See par. 17 above.

²⁰ Ex ante the Central Bank sets two implicit targets: an upper bound for real appreciation (nominal appreciation plus inflation) and an inflation target. In 2006 the upper bound for real appreciation was fixed at 9 percent and the inflation target was set at 8.5 percent. This comes down to a policy of fixed nominal exchange rate (OECD 2007).

²¹ The role of mandatory reserve requirements on the commercial banks and other sterilization instruments is very small in Russia (OECD 2006).

Bank. Even in the view that the Central Bank should focus more on combating inflation²² and let the Rouble appreciate more rapidly, its task is certainly eased by this role of the Fund.

23. In 2006 the IMF published a Report on Observance of Standards and Codes, Fiscal Transparency Module, on Russian budgetary institutions. The report observed that Russia had achieved considerable progress in fiscal transparency and financial management since 1990, but that a number of important reforms remained to be undertaken. The report noted that the legal framework of the budget process, the tax system and the financial relations between levels of government had been reformed and put on a modern footing. The Central Bank was seen as independent. Macro-economic forecasts were assessed as sound and open to scrutiny. Medium term budget policy was specified. Budget preparation was seen as transparent and the information provided to Parliament in conjunction with the budget as mainly adequate²³. Objectives of a number of programmes were announced and progress against these objectives was reported. Military expenditures and other security-related expenditures were included in the budget although at a more aggregate level than other expenditures. The creation of the Oil Stabilization Fund was seen as an important improvement. It was found that the Treasury system had strengthened budget execution, control and monitoring. In particular the 31,000 own resource accounts of federal entities were nearly²⁴ all brought under the Single Treasury Account. The report noted that the discretion in the execution of tax policy had been reduced. The accounting system was seen as comprehensive and accurate and monthly and annual reporting on financial outturns was found adequate although there remained some quality problems and delays. External audit by the Accounting Chamber of the Russian Federation was seen as independent, but the Chamber was found to focus on legal and financial compliance and not on performance. The legislation concerning privatization was seen as transparent. However, the report mentioned that the boundaries between the general government, the public enterprise sector and the private sectors needed further clarification. The report also noted that the regulation of the market sector in the sphere of competition, corporate governance and monopoly pricing was incomplete (for instance on take-overs and bankruptcy) and overly complicated. The report identified remaining weaknesses in the financial relations between levels of government particularly unfunded spending mandates, lack of spending autonomy on the part of sub-national governments and frequent changes in tax-sharing arrangements hampering the planning capacity of sub-national governments. The report noted that debt management was underdeveloped.

24. The OECD (2006) observed a number of institutional changes that pointed to a more active role for the state in the economy. In the late summer of 2005 a number of “national priority projects” were defined and implemented in the budget 2006. They aimed to provide substantial new resources to address chronic weaknesses in parts of the public sector that had long suffered from underfunding and neglect. The projects included: the health project, the education project, the housing project and the

²² This view is consistently put forward by the IMF in its annual art. IV reports on Russian financial policies, but not dealt by the Russian authorities (see note 9 above).

²³ The report noted however that at the time there was no separate reporting on tax revenues flowing from the oil sector and consequently no reporting on the non-oil balance, which was seen as a major weakness. This has been addressed since then. Similarly there was no reporting on governmental financial assets (considered as confidential) and only partial reporting on contingent liabilities and tax expenditures.

²⁴ Except some dozens of accounts mainly in the Defence sector.

agriculture project²⁵. Furthermore the budget of 2006 created an Investment Fund that was intended to provide financing for joint public-private investment projects that would stimulate socio-economic development by creating needed infrastructure of national significance, contributing to the innovation initiatives and facilitating structural change²⁶. The budget of the Investment Fund is relatively small (0.26 percent of GDP in 2006 and 0.34 percent of GDP in 2007). A third initiative concerns the creation of special economic zones on publicly owned land for 20 years. A law of 2005 makes it possible for regional governments to create such zones if they make significant commitments of their own. Residents of such zones are eligible for tax incentives²⁷. The state will also finance the creation of the zone's infrastructure. While commending the Government's efforts to stimulate investments as a key to continued rapid growth of the Russian economy, the OECD expressed a number of concerns in regard to the details of these initiatives. Among other things it mentioned that the Investment Fund would require an appropriate legal framework and that the support for national priority projects was not made dependent on structural reform in the areas concerned. According to the report it remained to be seen whether the new initiatives would escape the fate of previous state programmes in the sphere of investment and economic zones which had led to unimpressive results. The OECD also expressed concern about the rapid expansion of state ownership in key industrial sectors. Instead of imposing and enforcing a regulatory framework based on fair competition and best practice corporate governance the Russian government seeks to control these sectors by state ownership. According to the OECD survey the poor performance of existing state owned corporations suggests that expanded state ownership will likewise result in poorer performance of the companies affected.

25. As to fiscal rules, the OECD (2006) recommended to define a medium term fiscal target, based on an assessment of the non-oil fiscal balance and long run sustainability. The report recommended to reform the Stabilization Fund and to explicitly recognise its two different objectives: one part of the Fund should be considered as a buffer against oil price volatility while the other should be used to generate investment income. The yield of the investments could be used to finance a structural deficit. The tax base of the Fund should be broadened and include gas revenues. The minimum reserve of the buffer sub-fund should be increased to match the potential impact of a sharp drop in prices. The investment sub-fund should only gradually move to more risky assets to avoid mismanagement and to allow for capacity building.

26. The OECD (2006) paid extensive attention to the reform of public administration in Russia. It observed that Russia is still facing big problems in this area. It observed that public bureaucracies in Russia are little client oriented and suffer from endemic corruption. It found also that the institutions charged with administrative reform have little leverage over the bureaucracy. Nevertheless the report commended the Governments Concept for administrative reform of 2005 which is concerned with service

²⁵ In health and education the bulk of spending is on salaries for workers in these sectors who have long been among the worst-paid professionals in Russia. The housing project provides for credit guarantees and interest rate subsidy. The agriculture project provides for subsidies to the agricultural sector.

²⁶ Private sector applicants must submit their proposals first to the relevant ministry and subsequently to a commission attached to the Ministry of Economic Development and Trade. The final decision is made by a Government Commission chaired by the Minister of Economic Development and Trade.

²⁷ Tax incentives accorded to residents of such zones may include exemption from regional property taxes for the first five years, accelerated depreciation of capital investment, greater freedoms to carry over losses to following years, the subtraction of research and development costs from tax liability, the exemption from customs duty and VAT on imports and excise duties on domestic purchases and the exemption of customs duty, VAT and excises on exports.

quality, performance management and the organisation of service delivery (based to a certain extent on the ideas of New Public Management). In addition the OECD (2006) recommended that the Russian authorities should press ahead with institutional reforms that are preconditions for effective and efficient public administration (rule of law, freedom of information, parliamentary oversight), empowering citizens vis-à-vis the bureaucracy, fighting corruption and reducing the role of the bureaucracy in commercial affairs (deregulation, privatisation, separation of the state's ownership role from its other functions such as regulation and industrial policy).

27. In 2007 Russia thoroughly reformed its budget procedure. For this purpose the Budget Code was profoundly revised again. The reform was mostly consistent with the recommendations of the IMF and the OECD, particularly on fiscal rules and the management of the Oil Stabilization Fund and on the clarification between general government and the market sector. Another important institutional change was the introduction of three year budgets. These reforms will be addressed in the next chapter.

CHAPTER 2 BUDGET FORMULATION

Key characteristics

28. There are a number of features of the Russian budget formulation process, which merit special attention. These are:

1. Three year budgets
2. Fiscal rules
3. Extra-budgetary activities

Three year budgets

29. Three year budgets were introduced through the revision of the Budget Code in 2007. Starting from the budget year 2008, the federal budget and budgets of state off-budget funds are authorized for the next budget year and a two-year planning period²⁸. In practise budget formulation will be a rolling exercise, where a new second out-year is added to the budget as the former first out-year becomes the budget year. The appropriations in the out-years remain unchanged, but are inflated by the use of various indexes (including price indices in accordance with inflation forecasts²⁹) fixed by the Ministry of Finance and estimates of uptake of entitlements. It is estimated that 40-50 percent of federal budget appropriations finance entitlements.

30. New spending initiatives have in principle to be accommodated within an envelope of additional funds set apart in the budget of the previous year. In the budget 2008-2010 the envelope was set at 2,5 percent of total expenditure in 2009 and 5 percent of total expenditure in 2010. This envelope is based on estimated revenue growth, and is not specifically appropriated in the budget for the two out-years. In principle, all other spending is to be kept stable³⁰ in real terms at the line item level. The main discussion during budget preparation is consequently about the distribution of the non-allocated envelope, not about the adequacy of the existing three-year appropriations (apart from discussions about the updates).

31. In a comparative perspective this seems very similar to a budget process with multi-year estimates and ceilings as exist in a number of OECD countries that have moved to fixed expenditure frameworks (see box 1). The main difference being that the structure is codified as a three year budget. This allows budget holders to conclude multi-annual procurement and investment contracts and to develop medium term sectoral spending and performance plans. While some protection of multi-annual estimates is important for ministries so that they can plan, too much rigidity can also have disadvantages. A three year budget runs the risk of locking in expenditures, which might be problematic in a situation where fiscal retrenchment or large reallocations are needed (for instance to make room for new political priorities or large reforms). In the current environment of continuous real growth in the government budget and stable political priorities, this may not be seen as an issue, but it remains a potential problem. Indeed, one of important arguments in favour of multi-annual frameworks is that they facilitate retrenchments

²⁸ Regional and local budgets can cover one year or three years depending on regional legislation.

²⁹ In each three year budget the estimates for the out-years are based on current inflation forecasts.

³⁰ Namely as it was in the previous budget, which does not preclude growth from year to year.

and large reallocations because such measures need a long implementation trajectory. Under a fixed multi-annual framework such measures can be realized through reallocations within and between ministerial portfolio's and through cuts in extension years³¹. In principle, under a three-year budget only measures in the new out-year are possible for this purpose. However, there is some ambiguity here since under the Russian rules, some changes in estimates for existing programmes (reallocations, cuts, expansions) seem also possible by way of revision of the budget in a next three-year budget law or by a supplementary budget law during the budget year. However, these routes seem to undermine the very idea of three-year budgets.

32. In order to address this problem the Russian authorities may consider clarifying the rules about revision. In particular the rules could be sharpened so that it becomes clear that reallocations within and between ministries are possible, but only under the strict condition that the total of federal expenditures *on existing programmes (excluding the undivided envelope)* as established in the budget of the previous year, is not exceeded. This condition could explicitly be stated in the Budget Code. This would imply that the possibility of retrenchments and large reallocations is explicitly recognized. On the other hand it would mean that certain motives for revision that are now admitted, such as overspending on mandatory spending programmes, would be prohibited. Overspending would have to be compensated by savings on other programmes or, alternatively, would have to be financed from the distribution of the undivided envelope for the upcoming budget year. Such a provision in the Budget Code will create an incentive for ministries to provide cautious estimates for existing programmes (pessimistic rather than optimistic estimates). Ministers cannot expect any more that too low estimates for out-years will automatically be corrected in the next budget year, without impairing their claims to the undivided envelope in the next year. It will also encourage ministers to create undivided envelopes for out-years within their own budgets from which set-backs in existing programmes can be financed in future years. In addition and in line with such sharpened revision rules, the Budget Code could define a minimum size of the undivided envelope in the out-years and specify that the envelope is not only available for new spending initiatives but also for reallocation to existing programmes (in case of overspending) and for saving in periods of fiscal restraint.

³¹ In a rolling framework this can be done annually in the last out-year, in a periodical framework it can be done every two, three or four years in all years of the framework.

Box 1. Medium term expenditure frameworks

A medium term expenditure framework consists of a set of ceilings or targets for total expenditure, budget chapters (usually ministries and constitutional bodies) and social security funds in the medium term: the budget year and 1, 2, or 3 out-years. Many OECD countries work with a medium term expenditure framework. The framework is decided at the beginning of the annual budget cycle and provides a top-down direction to budget preparation. This does not mean that it makes no sense anymore for ministers to put forward proposals for new spending. However, such proposals have to be accommodated either within the ministerial ceiling/target or in the ceiling/target for the total (through reallocation between the ministerial ceilings). Typically the ceiling for the total is unalterable during budget preparation (particularly for the upcoming budget year), but the ceilings/targets for the ministries and social security funds are flexible and allow reallocation.

Apart from the discipline that follows from the early decision on the totals the main advantage of a medium term expenditure framework is that it allows planning in the medium term. New spending initiatives often begin small and finish big (camel noses). Under a fiscal framework the medium term consequences of new initiatives have to be made visible from the beginning. Multi-annual estimates for the new initiative have to be squeezed in under the multi-annual ceiling. It is important in this connection that multi-annual estimates for the new initiative are realistic and not biased in order to fit in with the ceiling. From a conceptual point of view the distinction between estimates and ceilings/targets is essential. Estimates are descriptive and should permanently be updated to fit reality. Ceilings/targets are prescriptive and should be as stable as possible.

Medium term expenditure frameworks are also important for the planning of retrenchments in times of fiscal restraint. Major cuts can usually not be implemented in the upcoming budget year, because they require longer preparation: amendment of entitlement laws, organisational overhaul, lay-off of personnel, etc. Medium term expenditure frameworks allow such cuts by phasing them in over the years of the framework.

Medium term frameworks can be used in two fundamentally different ways: either they can be put up anew at the beginning of every budget cycle or they can strictly be maintained over the years. In the first case the framework can be called flexible because it allows adjustment. In the second case it can be called fixed because the total of expenditures is maintained over the years. OECD countries such as Sweden, the Netherlands and the UK have moved to fixed frameworks. Other countries are considering this move (France, Hungary, Turkey). Fixed frameworks are not entirely unalterable. They typically allow reallocation between ministries from year to year, as well as updating for new inflation estimates. Moreover, the total can be changed from year to year under the strict condition of compensation by structural tax measures (tax relief requires lowering of the ceiling, the rise of the ceiling requires additional taxation). However, apart from these possibilities, the total of a fixed framework is unalterable from year to year. In this light a fixed framework can be seen as a fiscal rule: it imposes a multi-annual constraint on an important macro-budgetary parameter (expenditures). This further contributes to budgetary discipline, provides stability and predictability to the budget users and has an automatic macro-economic stabilization effect.

Fixed frameworks can be rolling or periodical. A rolling framework is updated from year to year (the unalterable total is confirmed) and a new out-year at the end of the planning period is added in each budget cycle. A periodical framework is also updated from year to year, but no new out-year is added. A periodical framework expires at the end of the planning period (usually coinciding with a cabinet period) and then a new framework is put up for the next planning period. Sweden has a rolling fixed framework; the Netherlands and the UK have periodical fixed frameworks.

33. Since the revision of 2007, the Budget Code contains a number of fiscal rules for the federal budget. These rules aim to put limits on the non-oil and -gas balance and the use of oil revenues for spending purposes. There are two aggregate limits: one for the non-oil and -gas deficit (non-oil and -gas revenue minus expenditures) and one for the regular budget balance. The non-oil and -gas deficit may not exceed 7.1% of GDP in 2008, 6.5% of GDP in 2009, 5.5% of GDP in 2010 and 4.7% GDP in 2011 and from then annually onward. In order to finance the non-oil and -gas deficit a transfer from oil revenue will

take place. This transfer may not exceed 6.1% of GDP in 2008, 5.5% of GDP in 2009, 4.5% of GDP in 2010 and 3.7% of GDP in 2011 and from then annually onward. This leaves the possibility of an overall budget deficit of 1.0% of GDP or less, which can be loan financed. Since Russia exhibits real growth well in excess of 1% yearly this in itself will mean that the debt/GDP ratio will be falling. This set of fiscal rules is summarized in table 4.

Table 4. Fiscal rules for the Russian Federation

Budget aggregates	Limits			
	2008	2009	2010	From 2011 onward
Non-oil and gas revenue	-	-	-	-
Total expenditures	-	-	-	-
= Non-oil and gas deficit	< 7.1 % GDP	< 6.5 % GDP	< 5.5 % GDP	< 4.7 % GDP
+ oil and gas transfer	< 6.1 % GDP	< 5.5 % GDP	< 4.5 % GDP	< 3.7 % GDP
= Budget Balance	> - 1.0 % GDP			

34. The remaining oil and gas revenues, that are not part of the transfer, are distributed to the Reserve Fund or the Prosperity Fund (see Box 2).

Box 2. The Reserve Fund and the Prosperity Fund

In 2007 the Oil Stabilization Fund fulfilled two functions, namely (1) insurance against volatility of the oil price, and (2) using oil windfalls in a macro-economically responsible way to generate future income streams that help to cover structural budget deficits. In order to separate the two functions more clearly, the Fund will be replaced in 2008 by the Reserve Fund, that will fulfil the price volatility insurance function, and the Prosperity Fund, that will fulfil the intergenerational equity function. The Reserve Fund is capped at 10 percent of GDP³². All revenues exceeding this cap are transferred to the Prosperity Fund. The tax base of the funds has been expanded: in addition to 95 percent of the proceeds of the mineral extraction tax and 100 percent of the export customs duty on oil production and export, 100 percent of the proceeds of the mineral extraction tax and the export customs duty on gas, flows into the funds³³. Finally, the switch mechanism for the oil and gas revenue flow between the budget and the funds has been changed: whether formerly the switch occurred when the cut-off price was reached, now there is a nominal oil and gas transfer which is defined in the three year budget law.

³² This is about five times as high as the 500 billion RUB minimum required by the former legislation. The 10 percent cap is based on the assumption that the Fund resources make it possible to smoothen the adjustment to a price drop of Urals crude oil from \$ 51.7 (the price assumed in the budget 2008-2010) to \$ 29.4 (the average price over the period 1997-2006).

³³ Natural gas extraction is taxed by the mineral extraction tax just as oil. In the case of gas the rate is 147 RUB per 1000 cubic meter. Gas condensate is taxed at a rate of 17.5 percent (ad valorem). The export customs duty is levied on gas at a rate of 30 percent of the customs value contract price.

35. The new fiscal rules are strict and assure sound fiscal management in Russia³⁴. As to the treatment of the oil and gas revenues there are some notable differences with the practices in Norway and the Netherlands. Norway does not allow any current spending from its oil revenues and puts 100 percent in the Norwegian Pension Fund. Only the proceeds of the fund, amounting to 4 percent of the accumulated equity is returned to the budget and can be used to finance a deficit. In this way the oil wealth is saved and produces an increasing flow of income to the benefit of future generations. The Netherlands split the gas revenue in a part that can be used for current expenditure and a part that is channelled into the Infrastructural Fund. The latter part can only be used for capital investment (mainly in the sphere of infrastructure). Given the present state of economic development and the urgent need to improve public services for the present generation³⁵, it is comprehensible that Russia wants to reserve a part of its oil revenues for current spending. Given this aim, it must be seen as a cautious arrangement that Russia has created the Oil Stabilization Fund (as from 2008 the Reserve Fund) to insure itself against the volatility in the oil revenue flow.

36. While all this is promising it remains to be seen to what extent the rules will be honoured. The path towards 2011 demands a marked decrease in the usage of oil revenue from 6,1% of GDP in 2008 to 3,7% of GDP in 2011. This will require strong political will and high economic growth to be politically acceptable³⁶.

37. The new Russian fiscal rules have various features in common with fixed multi-annual expenditure frameworks as can be found in some OECD countries (see box 2). However, the emphasis on targets for the non-oil balance suggests that there is still room for expansion of expenditures in case of windfall tax revenues (additional tax revenues flowing from unexpected growth as opposed to tax revenues flowing from new tax measures). This is explicitly recognized by allowance for the possibility that the envelope for new spending initiatives is extended beyond the undivided envelope of the first out-year of the previous three-year budget in the light of additional tax revenues. In so far as such an extension is indeed practised, the three year budget resembles more a flexible than a fixed expenditure framework (see box 2). A flexible framework does not impose inter-temporal discipline. Nor does it provide for automatic stabilization. In other words: a flexible expenditure framework is not an expenditure rule as commonly understood. Neither is the Russian three-year budget an expenditure rule as long as it maintains an annual limit on the non-oil balance.

38. The Russian authorities may consider moving to a fixed framework, possibly after some years of experience with the three year budgets. This could be done by removing the requirement on the non-oil balance and simultaneous exclusion of the possibility to extend the envelope for new spending beyond

³⁴ The new fiscal rules are mainly in accordance with the recommendations of the OECD (2006), except that on some aspects a still more cautious course is chosen (Resources of the Reserve Fund can only be invested in government bonds and not in more risky assets and yields of the Prosperity Fund have to be saved and cannot be used to finance structural deficits).

³⁵ Since in Russia the gap between the living standards of present and future generation must be expected to be larger than in more prosperous countries, some current spending out of oil-revenues is justifiable from the point of view of intergenerational equity.

³⁶ The IMF has noted that “the assumed spending cut of 2 percent of GDP was ambitious, considering that the federal government’s non-interest expenditures amount to only 16 percent of GDP” and that “much of the savings would have to come from socially difficult cuts in education, health and other social sectors in the run up to the 2011 elections – and that efficiency enhancing reforms in these sectors had stalled”. In reply the Russian authorities were adamant that the required retrenchments will be implemented (IMF 2007).

the undivided envelope of the previous budget. Of course there is then still a need to anchor the requirement on total spending in a balance target, but this target is a medium term target and the actual balance is allowed to fluctuate from year to year and “breath with the economy”.

Extra-budgetary activities

39. In accordance with the revised Budget Code of 2007, Russia is making large efforts to clarify the boundaries between the government sector and the market sector³⁷. Traditionally Russian finance statistics were based on the distinction between the *Government sector* and the *State sector*. The Russian *Government sector* is defined as entities subject to the Budget Code, which can be distinguished as federal entities, regional entities and local entities. The Government sector includes the commercial activities in which many of these entities engage (leading to non-tax revenues estimated by the Russian authorities at 2.5 percent of GDP). The *State Sector* includes the *Government sector* and *State unitary enterprises* at federal, regional and local level. *State unitary enterprises* are government owned but work on the basis of commercial accounts and commercial legislation. They are under ministerial responsibility, but off budget. They are auxiliary to a ministry’s activity, such as a printing house under the Ministry of Education or a production facility for police equipment under the Ministry of Justice. State unitary enterprises have a distinct legal status, different from regular market sector corporations. There are also many State unitary enterprises at the regional and local level³⁸. The State sector comes close to the concept of General government defined by international accounting standards (SNA 1993). The Russian government has been working hard to remove remaining differences. This has led to considerable improvements over recent years. For instance, the formerly off-budget revenues from commercial activities of federal entities (other than State unitary enterprises) and the off-budget expenditures financed from these revenues have now mostly been brought under the Treasury³⁹ and been put on budget⁴⁰. The main remaining problems concern the integration and consolidation of the expenditures and revenues of State unitary enterprises (in so far as they are not transferred to the market sector) and the commercial activities of regional and local governments, which are still largely off-budget (in the sub-national governments to which they belong). At present the total amount of off-budget non-tax revenue of sub-national government is estimated by the Ministry of Finance at 20 percent of total revenue of sub-national government.

40. In order to clarify the position of the State unitary enterprises, the Government is presently considering to create a new type of agency, namely that of “autonomous institutions”. State unitary enterprises that would opt for the legal status of autonomous institutions would keep their autonomy and be allowed to undertake commercial activities on an extra-budgetary basis. However, these institutions would belong to the market sector in public finance statistics and could no longer engage in (quasi-)fiscal activities, without being formally subsidized (on budget). Existing State unitary enterprises

³⁷ To the market sector (quasi-corporate sector in the terminology of the national accounts) belong both the public enterprise sector and the (commercial) private sector.

³⁸ IMF (2004) mentions 22.000 State unitary enterprises at all levels.

³⁹ Except some commercial activities in the sector of defence.

⁴⁰ The fact that non-tax revenues are brought under the Treasury does not automatically mean that they are put on budget. IMF (2004) mentions for instance a lawsuit by several educational institutions that wanted to keep non-tax revenues off-budget. The verdict held up this claim while maintaining that the revenues had to be handled through the Treasury account. The Ministry of Finance opposed this possibility.

would have to choose between the status of autonomous institution, regular government entity (on budget) or joint stock company. The status of State unitary enterprise would be abolished.

41. Apart from State unitary enterprises, the Government holds equity shares in some 3 700 joint stock companies. Many of these are involved in government activities or quasi fiscal activities and should be brought under the definition of general government or, if remaining in the (quasi-)corporate sector, explicitly subsidized. The energy sector (gas, electricity) is seen as the foremost area of quasi-fiscal activity. Russia has made large efforts to curtail this activity. In the budget for 2008, room is made for subsidies to Government owned enterprises, replacing quasi-fiscal activities, to the amount of 1.3 percent of total expenditures (0.2 percent of GDP). However, the practice of setting energy tariffs below cost recovery levels has not yet been abandoned.

42. The Russian Federation has over recent years pursued an active privatization policy concerning smaller State unitary enterprises and federally owned joint stock companies (in contrast to the nationalization policy concerning large industrial corporations). In the period between 1 June 2003 and 1 June 2006 the overall number of federally owned State unitary enterprises has shrunk due to their liquidation, transformation into joint stock companies and privatization by 2682 units or 27,2 percent of the total. The overall number of joint stock companies in which the Russian Federation held equity has shrunk in the same period by 481 units or 11 percent of the total. In June 2006 there were at the federal level about 7200 State unitary enterprises left and 3700 joint stock companies in which the Federation held shares (see chapter 4 for further detail). In addition there are many of those organisations at the regional and local level (estimated at 411 thousand as of 1 July 2006 , Rosstat 2007).

43. The success of budget reform in the Russian Federation is to a large extent based on the on the elimination of quasi-fiscal operations of State unitary enterprises and publicly owned joint stock companies and the shift toward more transparent ways of providing for public services. Against this background the recent introduction of a new type of unit, namely that of “state corporations”, is a reason for concern. State corporations are more autonomous in the management of their resources than autonomous institutions. However they have larger economic significance. There are now six state corporations, some already operating, some still in the stage of preparation. They operate in areas such as construction of Olympic facilities, production and export of high-tech merchandise, public utilities, housing, nanotechnology, banking and insurance. In 2007 the federal government contributed 550 billion RUB to the state corporations (10 percent of total budget expenditures). State corporations can borrow in foreign and domestic capital markets and issue bonds. Their loans are often guaranteed by the government. They can also cooperate with the private sector in public-private partnerships. It is very important that the legal status of the state corporations is clarified and that legal measures are taken to prohibit new quasi-fiscal activities of these corporations.

Budget formulation process

44. The present section will describe the budget preparation procedure in its present form, after the enactment of the Budget Code revision of 2007 which introduced the 3-year budget. This procedure was followed for the first time in 2007 for the budget 2008-2010. Because of the upcoming Duma Elections, the budget 2008-2010 was presented to the Duma on April 26 2007, whereas the (normal) deadline is August 26. In other words: the present budget preparation procedure is at the time of this review only tested once and the time table of this year deviated from the time table prescribed in the Budget Code.

45. The new budget formulation procedure is divided into two distinct parts. First, a technical update of the estimates for the upcoming budget year and the first out year as contained in last year's budget⁴¹, and the addition of current policy estimates for the second out year. Second, the distribution of the pre-set envelope for new spending in the budget year (with consequences in the out years) and the setting of the new spending envelopes for the new out years.

46. Table 5 shows the budget formulation calendar with the regular completion dates as well as the completion dates that have been applied this year.

⁴¹ Since in 2007 there was no previous three-year budget, for the budget 2008-2010 this updating exercise was based on the multi-annual estimates of the budget 2007.

Table 5. Budget formulation calendar

Regular time schedule	Activity completed	Time schedule Budget 2008-2010
February - March	Formulation and Approval by Budget Commission of tax and customs policy (January).	February-March
April - May	<ul style="list-style-type: none"> ● (Early) macroeconomic forecasts. ● Decision of macro-economic assumptions by Ministry of Economic Development and Trade. ● Technical calculation of ministerial baseline targets for upcoming budget law, i.e. adjusting estimates of the previous budget law for the coming 3 years, by Ministry of Finance for current expenditures and by Ministry of Economic Development and Trade for capital expenditures and current expenditures included in investment programmes. ● Line ministries receive Budget Circulars with base line targets from Ministry of Finance (current expenditures) and Ministry of Economic Development and Trade (capital expenditures and current expenditures included in investment programmes). ● Approval by Budget Commission and Government of the main directions of budget policy, including adjustment of entitlement legislation, new spending priorities and usage of the oil and gas transfer in the upcoming three year budget. 	
June -August	<ul style="list-style-type: none"> ● Line ministries allocate their baseline targets for 2008-2010 among their Main Budget Fund Administrators, further to be called main budget holders (responsible for the line items of the budget). ● Ministries present their proposals for baselines to Ministry of Finance (current expenditure) and Ministry of Economic Development and Trade (capital expenditures and current expenditures included in investment programmes). ● (June Economic Forecast, only in the regular time schedule) ● Approval by Budget Commission and Government of baselines (technical update). 	
	<ul style="list-style-type: none"> ● Decision of Budget Commission and Government on size of envelopes to be distributed and size of envelopes in out-years to remain undivided. ● Targets for new spending set by Budget Commission and Government and sent to ministries; negotiations with ministries. ● Ministry of Finance and Ministry of Regional Affairs discuss methods of grants to regions and local governments and decide mandate for negotiations between the Russian Federation and the regions for grant spending. ● Ministerial budgets for three years (including investments) decided by Budget Commission and Government. ● Ministry of Finance drafts three-year budget law. ● Ministries draft their Reports on Results and Activity and submit them to Ministry of Finance, Ministry of Economic Development and Trade and to the Commission for Budget Expenditure Efficiency Improvement. ● The Government approves draft budget law, draft Laws about the budgets of Pension Fund, Social Insurance Fund and Mandatory Health Insurance Fund for 2008- 2010. 	April
26 August	<ul style="list-style-type: none"> ● Government submits budget to the Duma 	26 April

Macroeconomic estimates

47. The Macroeconomic Forecast Department of the Ministry of Economic Development and Trade is in charge of developing initial macroeconomic forecasts, as well as of monitoring the current status of the economy. As a rule this Department produces four forecasts per year. In a normal year (not during the preparation of the 2008-2010 budget) an early forecast is produced in April and the forecast used for budget preparation is developed in June. The latter is updated and specified for industries and regions in August. The final version is produced in December taking into account the latest data on economic development during the current year and the approved Federal Budget. The versions of April and August are published. The versions of June and December are working documents for budget preparation and implementation. Forecasts are derived from economic models that are partly based on econometric estimation. Third party research is taken into account, for instance, forecasts of economic research institutes and banks.

48. The Ministry of Economic Development and Trade decides about the macroeconomic forecasts that go into the budget. These assumptions have to be agreed with the Central Bank of the Russian Federation and approved by the Budget Commission, which also resolves any disputes about the assumptions between the ministries. The Budget Commission consists of the Minister of Finance, the Minister of Economic Development and Trade, the Minister of Industry and Energy, the Minister of Defence, the Minister of Education, the Minister of Health Care and Social Development and the Chairman of the Budget Committee of the State Duma. Other ministers can be invited to the meetings of the Budget Commission if matters concerning their portfolio are being discussed. The Commission is chaired by the Prime Minister. He organizes the Commission's activities and monitors the implementation of its decisions. The tasks of the Commission include the review of:

- the medium term economic scenario-'s;
- the macro-economic assumptions for the upcoming budget;
- the draft of the Federal Budget, including the medium term financial policy and the financial balance;
- the proposals for changes in the tax and customs legislation;
- the proposals concerning public debt policy.

All recommendations of the Budget Commission are submitted to the Government for approval.

Technical updating current law

49. The budget formulation process starts with the Draft Budget Schedule of the Ministry of Finance detailing guidelines for budget submissions and the timetable for negotiations and meetings of the Budget Commission and the Government. The Draft Budget Schedule has to be agreed with the Ministry of Economic Development and Trade and the Ministry of Health Care and Social Development and adopted by the Budget Commission. Subsequently the Ministry of Finance sends out the Budget Circular which contains ministerial targets for the updating exercise which are basically the ministerial totals of the first out-year estimates of the previous budget, corrected for inflation (the Ministry of Economic Development and Trade issues a similar circular for capital expenditures). The deflators used may not always reflect the real price development of the ministry's inputs. Subsequently estimates are updated by main budget holders in line ministries. The estimation base is current policy. Entitlement estimates are updated on the basis of the latest estimates of eligible claimants over the three year period of the budget. Limited reallocation within ministries is possible during the technical update for reasons listed in

the Budget Circular. Finally, during the technical update estimates for the new second out-year are put up, also on the basis of current policy.

50. The results of the technical update are collected and reviewed by the financial directorate of the line ministries and discussed between the responsible Department of the Ministry of Finance (the Ministry of Economic Development and Trade in case of capital expenditure) and the line ministries (for the organisation of the Ministry of Finance see box 3).

51. Tax-revenue estimates are based on the latest macro-economic forecasts and current tax policies. This may include changes in fiscal legislation that have been approved by the Government and that will be submitted to Parliament in advance of the submission of the budget.

52. On this basis the Ministry of Finance drafts the baseline targets of the Federal Budget for the coming three years, split out by ministries and extra-budgetary funds. This is presented to the Budget Commission followed by Government approval.

Box 3. Organisation of the budget process in the Ministry of Finance

The budget preparation process is anchored in the Budget Policy Department of the Ministry of Finance, which consists of four divisions: Resource Funds; Budgetary Reform; Budget Execution Methodology; Budgetary Accounting, Reporting and Classification. The department has 24 staff including the Director and his five deputies. The negotiations with the line ministries about estimates and new spending are conducted by four sectoral departments: Industry; Social Affairs and Science; State, Military and Law Enforcement Services; State Administration, Judiciary, State and Municipal Services. The areas of responsibility are at present not aligned with ministerial portfolios. For reasons of efficiency the boundaries between the Departments will be revised in order to correct this. It is estimated that all in all about 500 people are involved in the budget process in the Ministry of Finance and the Ministry of Economic Development and Trade.

New funds allocated

53. The second stage starts with a decision by the Budget Commission and the Government about the size of the envelopes for new spending in the budget year and the out-years. For the budget year and the first out-year these envelopes may in principle be held at their previous levels or be expanded with room that may become available from new revenues. The envelope for the second out-year has to be determined in the light of the expenditure baselines and revenue estimates. The envelope for the budget year is up for distribution.⁴² Any new spending in the budget year will work through in the out-years and will limit the undivided envelopes in the out-years. The aim to keep the undivided envelope in the out-years at a certain size may have consequences for the way the envelope in the budget year is spent (no camel noses). During budget preparation 2008-2010 the undivided envelopes for the first and second out-year were put at 2.5 percent of budget expenditures (2009) and 5 percent of budget expenditures (2010).

54. The Budget Commission and the Government decide on the ministerial targets for the new spending initiatives and the split in these targets between current and capital expenditures. Subsequently, line ministers, supported by their financial directorates, develop their own new spending proposals (see box 4 for the internal process in a line ministry). Then starts a process of negotiations

⁴² These observations are based on reasoning (from the revised Budget Code) rather than on experience, since there was no previous three year budget when the budget 2008-2010 was put up.

between the line ministries and the Ministry of Finance (Ministry of Economic Development and Trade in case of capital expenditure). Discussions focus on new expenditures but may also involve reallocations larger than allowed in the technical updating exercise. Agreement has to be reached about the following issues:

- The total amount and profile of new spending initiatives⁴³;
- Amendment of expenditure limits (ministerial totals) for the budget year and the first out year⁴⁴;
- The expenditure limit (ministerial total) for the second out-year⁴⁵;
- Funds to be reserved for the national priority projects⁴⁶.

Box 4. Budgeting in Ministry of Culture and Media

The Minister of Culture and Media is responsible for the ministry and its agencies⁴⁷ including the Bolshoi Ballet, The Hermitage Museum and the National Film Archives. The ministry's budget is developed in the Economic and Financial Department, which has a staff of 40. This department includes separate units for Medium and Long Term Budget Prospects (6 staff), Targeted Programs (6 staff), Accounting (6 staff) and Internal control (6 staff).

As discussed above there is a split between the technical updating of the current appropriations and the distribution of the envelope for new initiatives. In 2007 the Ministry of Finance has handed out the budget targets for the updating exercise in February (normally this would be in April, see table 4). These were then transmitted to the budget holders within the ministry. The targets are basically the same as the previous years' estimates for the out-years, after indexing according to the consumption price index. Budget holders then put up their own estimates, both for the updating exercise and for new spending initiatives. The Economic and Financial Department collects the proposals. In general, the ministry will take over only a limited number of proposals for new initiatives. During the budget preparation process there will be discussions with the Ministry of Finance first concerning the updating of estimates and next on the costing of the new initiatives. These discussions will typically reach the political level one or two times per year. New spending initiatives have to be approved by the Budget Commission and the Government.

There is not yet a budget preparation IT-system in the Ministry of Culture and Media. The budget is produced by sending Excel sheets to the Ministry of Finance. The Ministry of Finance produces the budget documents and the appropriations tables.

55. If issues cannot be resolved bilaterally between the line ministry and the Ministry of Finance, they are submitted to the Budget Issues Sub-Commission of the Budget Commission chaired by the Minister of Finance (for capital expenditure: Economic Issues Sub-commission of the Budget Commission, chaired by the Minister of Economic Development and Trade). The outcomes of the reviews conducted by the Sub-Commission are formalized in a memo and submitted to the Budget Commission, which makes the final decisions or submits political issues to the Government.

⁴³ This implies that agreement is not required at line item level.

⁴⁴ The expenditure limit is the baseline plus the ministry's share of the distributed envelope.

⁴⁵ The limits mentioned in this and the previous bullets do not include the undivided envelopes for the out-years since these envelopes are held at the Ministry of Finance.

⁴⁶ See chapter 1 par.24.

⁴⁷ For the concept of agency see chapter 4, par. 129.

56. The purpose of the Budget Commission is to resolve most of the issues up to certain political threshold. However, the process is in reality less clear, as ministers may find ways to circumvent the process in order to further their budgetary interests. This can take the form of attempts to solicit favourable decisions from the Prime Minister or the Minister of Finance outside the Commission process (after which this process can be ignored). The process could be improved and made more efficient if the Budget Commission would focus more clearly on technical matters (macro-economic assumptions, the updating exercise leading to the baselines, revenue estimates, the size of the undivided envelope in the out-years), and leave political matters (the distribution of the spending envelope over ministries and new spending initiatives, major reallocations) to the Government. In this way the Budget Commission could probably be “depoliticized” to a certain extent. If such a reform would be considered, the composition of the commission could also be looked at. Various OECD countries work with a financial-economic core cabinet. Apart from the Prime Minister, the Minister of Finance and the Minister of Economic Affairs, often the Minister of Social Affairs (responsible for the labour market and social security), and the Minister of the Interior (responsible for the financing of sub-national government) participate in such a group, but typically not the Minister of Defence and the Minister of Education who have large sectoral spending interests.

57. Until 2008 the budget formulation process in Russia was split between appropriations for current expenditure, coordinated by the Ministry of Finance, and appropriations for capital expenditure coordinated by the Ministry of Economic Development and Trade. This split also involved an early decision on the share of investment in the envelope for new spending coming up for distribution. During budget preparation 2008-2010, 15 percent of the envelope was earmarked for capital expenditure. Although this split exists in various countries, in OECD countries it does not occur any more (Turkey being an exception). The Russian government has very recently decided to transfer the supervision of capital spending from the Ministry of Economic Development and Trade to the Ministry of Finance. This decision should lead to a less fragmented budget process, improved linkage between capital and current expenditures and a better trade off between public services. It seems logical that this decision will also have consequences for the budget circular (no separate budget circular any more for capital expenditure), the budget requests for baselines and new spending initiatives (no separate requests any more to the Ministry of Development and Trade) and the functioning of the Budget Commission (no separate Economic Issues Sub-Commission any more).

58. Concentration of financial supervision in the Ministry of Finance is an important step forward but it is not sufficient for a good linkage between current and capital spending. For that purpose it is necessary that each line ministry has authority over the capital expenditures that are immediately relevant for its mandate (and its current expenditures). That is presently not the case. The reason is mainly historical, in particular the development of various types of “targeted programmes”, which are administered and funded in processes that are not well integrated in the regular budget process. Furthermore, the Investment Fund⁴⁸ creates additional fragmentation of investment planning.

59. There are four types of targeted programmes at the federal level: “Federal Targeted Programmes” (FTP’s), the “Federal Investment Targeted Programme” (FITP), “Departmental Targeted Programmes” (DTP) and “Long Term Targeted Programmes” (LTP). FTP’s were meant for large scale investments and scientific programmes. The Minister of Economic Development and Trade is responsible for their administration and budget. FTP’s often lacked effective management mechanisms and were not well coordinated with the responsible ministries. Their number has been reduced from 149 in 2004 to 50 in

⁴⁸ See chapter 1, par. 24.

recent years. The FITP compiles information on budget investments in FTP's but also other (related) investment projects. The minister of Finance is responsible for the budget of the FITP while the Minister of Development and Trade is responsible for the selection of projects. Investment projects included in the FITP with a budget of over 8 billion RUB are reflected in the budget in a separate line item (in the budget classification, see chapter 4, box 6 below). Smaller investment projects will be reflected in aggregate line items. DTP's are investment programmes administered and funded by line ministers. LTP are a new form of investment programming that will be introduced as of 2009. LTP's are also administered and funded by line ministries but they will be reflected in the budget as separate line items (because of their size and importance).

60. The Investment Fund is not well integrated in the budget process and not linked with current expenditures required for project implementation. The tools for using the Fund's resources are not properly developed and do not allow to prioritize the projects. This results in under-exploitation of the Fund's resources and accumulation of its reserves. At the same time it is expected that by 2010 the Fund's resources will not be sufficient for the implementation of large scale projects to be undertaken.

61. It is recognised by the Russian authorities that the present processes for investment planning are complicated and not well coordinated with the budget process. Separate planning of capital expenditure and related current expenditure (for maintenance, exploitation, etc.) has led to negative consequences such as uncompleted construction projects, prolongation of construction terms, and high exploitation costs of completed projects. For the future it is important that investment planning is entirely integrated in the regular budget process of the line ministries that are responsible for the policy sector. This requires that the Minister of Transport has authority over infrastructure, the Minister of Defence over weapon systems, the Minister of Urban Development over public housing, etc. If Russia wants to go this way, it is recommendable to simplify the investment planning procedures. OECD countries usually have only a single sectoral planning document for the medium and long term, for instance for transport, defence, water resources, etc. This document treats both capital and current expenditure and the resulting performance in a fully integrated way. It is entirely under the authority of the sectoral minister. This minister is also responsible for the administration and funding of all investment projects in his/her sector. Possibly the Long Term Targeted Programmes (LTP's) that are foreseen in the amended Budget Code can evolve into this type of document, but this would require a considerable simplification and clean-up of the remaining procedures and institutional setup. In a transition period it may be useful to maintain a "light" form of coordination in the Ministry of Economic Development and Trade, for instance by way of a "knowledge centre" that can perform cost-benefit analysis on project proposals and provide line ministries with advise about technical aspects of investment projects. The need for the Investment Fund, which apart from the mentioned problems, does not function properly and is too small for the projects for which it has been established, should be reconsidered.

62. The financial directorates of the line ministries play a key role in the budgetary process. These directorates are also a crucial factor in any policy to improve the efficiency and effectiveness of public spending and to enhance budgetary control. Financial directorates must be able to coordinate the budget process inside the line ministries and to provide countervailing power to the budget holders of the ministry. At present the financial directorates of a number of line ministries fulfil a more traditional bookkeeping role. The Russian ministry of Finance has taken initiatives to mark up the capacity of financial directorates. These initiatives should be pursued energetically. Training programmes and international exchange can be useful tools for this purpose.

Performance and the budget preparation process

63. Since 2004 budget holders annually compile reports on targets and results in their main areas of responsibility. These reports are integrated by the Minister of Economic Development and Trade into an annual report on targets and results of the Government. The report contains strategic goals, elaborated in measurable targets and time series data on the relevant indicators for all sectors of federal policy. For instance, the strategic goals for the Ministry of Finance are: creating and implementing the budget, effective management of state liabilities, good tax management, and macroeconomic stability in Russia. Target indicators include the credit rating of Federal bonds, several inflation indicators, etc. The general report is published.

64. The Parliament does not receive the performance reports (nor the ministerial nor the general report) and these are not attached to the Budget Documentation. These results are rather considered by the Government Commission on evaluation of effectiveness of federal and regional executive authorities. Assessments are also conducted by the Ministry of Economic Development and Trade and the Federal Statistics Office. So far data on results hardly play a role in the budget process.

65. The role envisaged for performance information in the future is not entirely clear. However, the procedures are very new. At present the main role of performance information is transparency: to show what outputs are being produced in the public sector. On this basis a more evidence based debate with parliament and civil society about the merits of current policies becomes possible and ministers can better be held to account. However, the role of performance information in sectoral policy development is different than in the budget process. In OECD countries there are widely different approaches concerning the role of performance in the budget process. Some countries that in the past have published large amounts of performance information in the budget documentation have made steps back and have now largely relegated this information to sectoral policy documents (for instance: the UK, the Netherlands, Australia, New Zealand). For Russia it is important to clarify the role performance information should play in the budget process, if any, before further steps are taken to publish large amounts of such information in the budget documentation (as opposed to sectoral policy plans). Otherwise the risk is not imaginary that the transparency of the budget documentation is impaired rather than enhanced by such information.

The President's Budget Address

66. Formally the role of the President in the budget process is limited. However, there are counsellors in the Presidential Administration for every ministry, including the Ministry of Finance. Counsellors are generally kept informed about the progress of the budget process by line ministries and they may work with the counsellors for the Ministry of Finance and the Prime Minister in order to provide advise to the Prime Minister and the Minister of Finance.

67. The President plays a formal role during the President's Budget Address to the Duma in May (also this year in May in spite of the compressed time schedule). This address precedes the actual submission of the Budget and highlights the features of the Budget that the President wants to emphasize. In this year's budget address much emphasis was put on the need to measure and control performance. Also the President exposed many of the strategic goals of the Government in the areas of national priority projects (health, education, housing, agriculture) but also in areas like pensions, public sector salaries, infrastructure and defence.

Conclusions

68. The recent revision of the Budget Code in Russia has introduced three-year budgets, strict fiscal rules and considerable constraints on extra-budgetary activities of government units and public enterprises. This amounts to large progress in the control of public spending.

69. Three-year budgets provide predictability to public spending, allow line ministries to conclude multi-annual contracts and to plan on the medium term and oblige budgetary authorities to consider the multi-annual consequences of spending initiatives. A potential risk in a situation of less buoyant revenue growth is that three year budgets lock in expenditures and that large reallocations and expenditure cuts become impossible. Although the rules of the Russian Budget Code seem to allow some changes in estimate for existing programmes, this possibility seems to undermine the very idea of three year budgets. More clarity on this point could be created by clarification of the rules about revision. In particular the rules could be sharpened so that it becomes clear that reallocations within and between ministries are possible, but only under the strict condition that the total of federal expenditures *on existing programmes (excluding the undivided envelope)* as established in the budget of the previous year, is not exceeded. This condition could explicitly be stated in the Budget Code. This would imply that the possibility of retrenchments and large reallocations is explicitly recognized. On the other hand it would mean that certain motives for revision that are now admitted, such as overspending on mandatory spending programmes without compensation, would be prohibited.

70. The new fiscal rules are strict and assure sound fiscal management in Russia. The new rules for the Oil Stabilization Fund are prudent, insure the government sector against the volatility of the markets for hydrocarbons, provide for intergenerational equity and fulfil an important role in monetary policy.

71. Since the new fiscal rules steer on the non-oil balance and allow for extension of the envelope for new spending beyond the undistributed envelope of the previous budget in the light of additional windfall revenue, they cannot be seen as expenditure rules. The Russian authorities may consider moving to an expenditure rule, possibly after some years of experience with the three year budgets. This could be done by removing the requirement on the non-oil balance and simultaneous exclusion of the possibility to extend the envelope for new spending beyond the undivided envelope of the previous budget. Of course there is then still a need to anchor the requirement on total spending in a balance target, but this is a medium term target and the actual balance is allowed to fluctuate from year to year and “breath with the economy”.

72. The efforts of Russia to remove off-budget spending in the government sector are impressive. The main remaining problems concern the integration and consolidation of the expenditures and revenues of State unitary enterprises (in so far as they are not transferred to the market sector) and the commercial activities of regional and local governments. It is important that efforts to tackle these problems are continued and brought to completion.

73. The efforts of Russia to terminate quasi-fiscal spending by public corporations in which the Russian Federation holds a stake are also impressive. However, much remains to be done, especially in the energy sector. In a first stage this does not necessarily require an overhaul of the existing regime of price regulation, but rather the introduction of explicit on budget subsidies to the energy sector, possibly accompanied by revision of the tax regime in order to achieve budget neutrality.

74. The success of budget reform in the Russian Federation is to a large extent based on the elimination of quasi-fiscal operations of State unitary enterprises and publicly owned joint stock

companies and the shift toward more transparent ways of providing for public services. Against this background the recent introduction of a new type of unit, namely that of “state corporations”, is a reason for concern. It is very important that the legal status of the state corporations is clarified and that measures are taken to prohibit new quasi-fiscal activities of these corporations.

75. The role of the Budget Commission is not entirely clear. The functioning of the Commission may be improved by limiting its mandate to technical aspects of the budget, such as the review and approval of the macro-economic assumptions, the baselines and the revenue estimates. Other more political aspects of the budget could be submitted directly to the Government.

76. The decision to transfer the supervision of capital spending from the Ministry of Economic Development and Trade to the Minister of Finance should lead to a less fragmented budget formulation process, improved budgetary control and better trade off between public services.

77. The Russian authorities may consider taking a further step on this road and transfer capital spending that is immediately relevant for current expenditures to the budgets of the ministries concerned, while maintaining a light form of coordination in the Ministry of Economic Development and Trade. In this connection it is recommended that the present planning procedures for various kinds of “targeted programmes” are simplified. A single sectoral planning document under the Ministry that is responsible for the policy area suffices. This document has to cover both capital and current spending. Possibly the Long Term Target Programme, foreseen in the recent amendment of the Budget Code could develop into such a document. The Investment Fund, which causes further fragmentation, does not function properly and is too small for the projects for which is established, should be reconsidered.

78. The Russian Ministry of Finance has taken initiatives to mark up the capacity of financial directorates. These initiatives should be pursued energetically. Training programmes and international exchange can be useful tools for this purpose.

79. Russia has made large efforts to develop performance information about public spending programmes. So far performance information is not part of the budget documentation that is submitted to the State Duma. This is a prudent approach that is consistent with the developments in other OECD countries. For Russia it is important to clarify the role performance information should play in the budget process, if any, before further steps are taken to publish large amounts of such information in the budget documentation (as opposed to sectoral policy plans). Otherwise the risk is not imaginary that the transparency of the budget documentation is impaired rather than enhanced by such information.

CHAPTER 3 PARLIAMENTARY APPROVAL

Budget submission

80. According to art.105 of the Constitution of the Russian Federation, federal laws have to be adopted by the State Duma and approved by the Council of the Federation. This also holds for the annual budget law⁴⁹. According to art. 114 of the Constitution the Government submits the budget law to the State Duma. The right of initiative, including amendment, on the part of the Parliament is granted in art. 104 of the Constitution and further elaborated in the Budget Code.

81. The Budget Code explicitly embraces the principle of openness, mandating the government to publish the approved budget law and budget execution reports and to make this information available to the legislative bodies at all levels of government (art 36).

82. In addition the Budget Code enumerates an extensive set of documents that have to be submitted in conjunction with the budget bill (art. 192, par. 4 and 5). This includes:

- the draft budgets of the extra-budgetary funds;
- preliminary results of socio-economic development during the year preceding the budget year and forecast of socio-economic development over the planning period (of three years including the budget year);
- preliminary budgetary results over the year preceding the budget year;
- main directions of budget and tax policy over the planning period;
- an explanatory note on the budget and tax policy over the planning period;
- the sources of deficit financing in the budget year and the planning period;
- a list of commitments for the budget year and the planning period;
- an explanation of the financing of the regions by federal means and tax sharing arrangements in the budget year and the planning period;
- reports on the implementation of federal targeted programmes⁵⁰;
- the upper limit and structure of federal debt in the budget year and the planning period;
- a draft programme of federal loans, including export loans, in the budget year and the planning period;
- a draft programme of borrowing in the budget year and the medium term;
- an upper limit on federal guarantees at the end of the budget year and at the end of the planning period;

⁴⁹ However, whereas other laws are assumed to be approved by Council of the Federation if they are not examined within fourteen days after they have been submitted, budget laws must compulsorily be examined by the Council of the Federation (art. 106 of the Constitution).

⁵⁰ See Chapter2, par. 59.

- calculations of the use of the federal oil and gas revenues in the budget year and the planning period and the assets of the Reserve Fund and the Prosperity Fund at the end of the budget year and the end of the planning period.

Box 5. The Russian Parliament

Russia's Federal Assembly – the representative and legislative body of the Russian Federation – is structured as a bicameral parliament. The Lower House is called the State Duma. It comprises 450 members, each elected for a period of four years through a system of proportional representation. At present there are 4 factions registered in the State Duma (5th convocation of the State Duma 2008-2011): (1) United Russia (315 members), (2) Communist Party (57 members), (3) Liberal and Democratic Party (40 members), (4) Righteous Russia (38 members). The Upper House is the Council of the Federation. It comprises 170 members. The members of the Council are elected by the regions. Each region is represented by two members, one is elected by the legislative body of the region and one is appointed by the Government of the region with the approval of the legislative body.

83. Changes in tax legislation are debated and decided before the submission of the budget bill. Since the Tax Code requires that each law establishing new taxes or fees is to come into force not earlier than the 1st January of the year following the year of its adoption and not earlier than one month before its official publication (art. 5 of the Tax Code), the budget can be based on firm assumptions concerning the revenue side (tax changes cannot be implemented during the budget year if they have not been adopted in the previous budget year).

Parliamentary procedure

84. The Budget Code states that the Government is to present the budget bill to the State Duma not later than August 26 (art. 192). The Federal Assembly is given up to 99 days to review the budget bill; this period is divided by a rather tight budget calendar. The State Duma considers the budget bill in three readings. The Council of the Federation considers the budget in one reading.

Table 6. Parliamentary Budget Calendar

Until August 26	Submission of the draft federal budget law by the Government to the State Duma.
<i>Within 30 days after submission (not later than September 25)</i>	First reading leading to approval of the totals of expenditures, revenues and the balance.
Within 35 days after first reading (not later than October 30)	Second reading leading to approval of the totals for ministries and agencies, financing sources of the deficit, totals for the expenditure functions ⁵¹ , transfers to extra-budgetary funds and sub-national governments, the programme of federal loans, the programme of borrowing, the programme of guaranties and the expenditures for each of the targeted programmes ⁵² .
Within 15 days after second reading (not later than November 14)	Third reading, leading to approval of the line item estimates and thereby of the draft budget law as a whole.
Within 5 days after third reading (not later than November 19)	Submission of the federal budget law as approved by the State Duma to the Council of the Federation.
Within 14 days after submission (not later than December 3)	Single reading in the Council of Federation leading to approval or rejection of the federal budget law.
Within 5 days after reading (not later than December 8)	President's signature.

85. The time table prescribed by the revised Budget Code of 2007 has shortened the parliamentary procedure (see table 6). Whereas in the period 2001-2007 the procedure took place in four readings and took from 104 to 123 days, in 2007 it took only 86 days to pass the budget law 2008-2010. The new time table will guarantee that the new budget is in place at the beginning of the budget year, which is a clear improvement.

86. According to the Constitution and the Budget Code, the Parliament has the right to amend the draft budget law submitted by the Government. However, changes in the revenues or the deficit and hence in the totals of expenditures require the agreement of the Government (art. 201 of the Budget Code).

87. Amendments can be put forward in the State Duma by the "subjects of legislative initiative", namely President of the Russian Federation, the Government, the Council of the Federation and its members and the members of the State Duma. In addition the regions, the Supreme Court, the Constitutional Court and the High Arbitrage Court can put forward amendments in the area of their competences. All amendments must be considered by the State Duma (art. 104 of the Constitution).

⁵¹ The line item classification of the budget consists of about 3800 appropriations and is hierarchically ordered. The second highest ordering is a functional classification that is comparable in level of aggregation to the second level COFOG classification of the international accounting standards (but not entirely identical). For the Russian budget classification see further chapter 4.

⁵² See chapter 1 par. 59.

88. The first budget reading deals with the budget aggregates: totals of revenues and expenditures and the deficit. If the State Duma rejects the aggregates, it has three options (art. 202 of the Budget Code): (1) to submit the budget bill to a reconciliatory commission of representatives from the State Duma, the Council of the Federation and the Government in order to reach agreement, (2) to send the draft budget law back to the Government with the request to submit an amended draft, and/or (3) to call for a vote of confidence in the Government. Ultimately an amendment of the aggregates must be agreed by the Government. Once the totals are approved, the aggregates cannot be changed in the following parliamentary hearings.

89. The second reading of the State Duma deals with the functional expenditures totals and a number of specific issues (see table 5 above). This reading is prepared by the Committee on Budget and Taxes of the State Duma (consisting of 45 members). The Committee first collects the amendments proposed by the subjects of legislative initiative and groups them for discussion in the relevant sector committees. The decisions of sector committees are then collected, combined by the Committee on Budget and Taxes into an opinion, which is voted on by the State Duma. Some amendments can only be considered by the State Duma with agreement of the Government, namely amendment to expenditures for federal targeted programmes, investments in State property and grants to sub-national governments and some specific public corporations.

90. During the third reading in the Duma, expenditures are presented according to line items, and the members of the State Duma vote on the draft budget law as a whole. The vote leads to approval or rejection, and no further amendments can be made. This third reading provides the final vote on the budget. The State Duma can reject the budget as a whole at this stage, and send it to the reconciliatory commission for review.

91. Apart from the formal procedure of three budgetary readings described above, an additional, informal procedure has been established in the last few years. It is known as the “zero-reading”, in which representatives of the Ministry of Finance present the budget outline to representatives of the factions of the State Duma and the Council of Federation, approximately one week before the draft is officially submitted to the Federal Assembly. This reading seems to have come in use with the purpose of “testing the waters” before the budget is actually submitted and makes it possible to make last minute adjustments.

92. Once the draft budget law is approved by the State Duma, it is submitted to Council of Federation. Like in the third reading of the State Duma, this reading is also carried out as a review of the entire budget and it cannot lead to amendments. The Council of Federation has the right to approve or reject the budget. If the budget law as approved by the State Duma is rejected by the Council of the Federation it will be submitted to a reconciliatory commission.

93. While the State Duma has not yet ever held a public hearing about the budget, the Council of Federation conducts one public hearing on the budget every year since 2001. These hearings take place in the middle of September, which is after the submission of the draft federal budget to the State Duma and during the preparations for the first reading of the State Duma. While this public hearing is open to the public, it is attended mostly by government officials, the accredited press, and invited public finance experts. The hearing is conducted in the form of speeches and there is virtually no discussion.

94. The President has the right to reject the budget law as approved by the Federal Assembly. In this case too, the law would be submitted to a reconciliatory commission. In this case the commission would comprise additionally the representatives of the President.

95. Since 2000, when the Budget Code entered into force, it has never occurred that the budget law was rejected by the Parliament. In the period 1995-1999 the draft law has been sent to a reconciliatory committee in five cases, whereupon the modified version has been approved. In 2007 the total number of proposed amendments was 1505, of which 553 were approved and 952 rejected; the total amount of reallocation comprised in the approved amendments was 27.3 billions RUB or 0.5% of total federal expenditures. The totals of expenditures, revenues and the balance have never been changed in the final version of the budget law approved by the Parliament as compared with the draft submitted to the State Duma.

96. The openness and transparency of the parliamentary budget process could be improved by holding public hearings (not only in the Council of the Federation but also in the State Duma) and by organising these hearings in the form of an open debate between experts. This would also make it more attractive for the mass media to report about the hearings as well as about the subsequent plenary sessions.

97. The State Duma has insufficient control over its own budget and staffing. In most OECD countries the Government does not interfere in the control of the Parliament over its own budget, as this is considered as a sequel of the separation of powers. In particular the Committee on Budget and Taxes of the State Duma seems to have insufficient staff capacity to enable its members to develop an independent judgment on non-political aspects of the budget, such as the quality of the macro-economic forecasts, the accuracy of the medium term expenditure estimates and the reliability of the data that the government puts forward in support of its new spending proposals.

Amendments during the Fiscal Year (supplementary budget laws)

98. During the budget year, the Parliament is authorized to approve amendments to the budget that are submitted by any subject of legal initiative⁵³ (art.213 of the Budget Code). Other subjects than the Government can only submit amendments if total revenues are more than 10 percent higher than estimated in the current budget laws. The procedure foresees that a federal supplementary budget law must be approved in three readings, within 25 days. In recent years from 2 to 6 supplementary laws have annually been approved in this way. Most changes have been initiated by the Government and some by the State Duma. In 2006 and 2007 the Government has used this procedure to introduce substantial expenditure packages during the budget year.

Conclusions

99. The Budget Code prescribes an open and transparent parliamentary budget process. The Budget Code enumerates an extensive set of documents that have to be submitted in conjunction with the annual budget bill. The Code prescribes a specific time table for the parliamentary budget procedure that provides sufficient time for scrutiny and parliamentary initiatives. The Code contains constraints on amendments that serve to protect budgetary discipline. Such constraints can also be found in many OECD countries.

100. The parliamentary time table prescribed by the amendments of the Budget Code of 2007 has led to a considerable shortening of the parliamentary procedure and is a clear improvement.

⁵³ See par. 87 above.

101. The openness and transparency of the parliamentary budget process could be improved, for instance by holding public hearings (not only in the Council of the Federation but also in the State Duma) and by organising these hearings in the form of an open debate between experts.

102. The State Duma has little control over its own budget and staffing. The Committee on Budget and Taxes could benefit from additional staff providing non-political expertise on macro-economic and budgetary issues.

CHAPTER 4 BUDGET EXECUTION

Organisation of budget execution

103. Within 15 days after the budget has been approved and signed by the President, the Ministry of Finance issues the so called 'Consolidated List of Appropriations'. This document lists all line item appropriations (about 3800) of the federal budget and distributes them among ministries.

104. Subsequently ministries distribute the appropriations among main budget holders and budget holders in the form of "commitment limits". Each main budget holder is responsible for one or more line item appropriation(s) and each budget holder represents a spending unit. The list of the federal main budget holders is established by the annual budget law. For example, the Ministry of Education divides the appropriation for the funding of universities into commitment limits for each university. All in all, approximately 60,000 spending units receive funds from the federal budget.

105. The total sum of commitment limits cannot exceed the total sum of appropriations, but ministries may set the commitment limits up to 10 percent lower than the appropriations authorized in the budget law and thus hold back money that can be used during budget execution for reallocation.

106. Budget holders have to break down their commitment limits in terms of types of inputs, such as salaries, procurement, investments and grants (an economic classification). This break down is not part of the line item classification of the budget law (see box 6). Until 2008 the break-down in types of inputs had to be approved by the Ministry of Finance, as from 2008 by the line minister.

107. Resources are made available in quarterly instalments of the commitment limits broken down in types of inputs.

Box 6. Classification of appropriations in the annual budget law

Line item appropriations in the Russian annual budget law consist of three parts: (1) administrative groups (3 digits in the code of the chart of accounts); (2) basic functional groups (4 digits in the code of the chart of accounts); and (3) targeted programmes and types of expenditures (10 digits in the code of the chart of accounts). The classification goes into more or less detail, depending on needs. All in all, approximately 3,800 line items are specified according to this classification (each with a code-number of up to 17 digits).

The administrative classification specifies line items according to groups of main budget holders (ministries, agencies, services⁵⁴ and some other large organizations).

The basic functional classification is roughly comparable to the first and second level of the COFOG classification of the international accounting standards: 2 digits for first level (section) and 2 digits for second level (sub-section).

The last part of the classification is a more specific functional classification (seven digits for targeted investment items and three digits for types of expenditures). It is an instrument for the government and the parliament to keep track of funds for specific projects. This is done for example for all investment expenditure included in the Federal Investment Targeted Program (FITP) above 8 million roubles.

The economic classification (3 digits) is not part of the line item classification of the budget. However, together with the code of budget accounts (6 digits) it is part of the integrated budgeting and accounting chart of accounts (each account characterized by a code-number of up to 26 digits).

108. After budget holders have received their commitment limits, and the budget year has started, they are free to spend the room under the limit. No prior approval of contracts is necessary. When payments are due, the budget holder sends a payment order to the Treasury, which executes the payment. The Treasury checks the payment order against the commitment limit and executes the payment if the commitment limit allows it.

109. Budget holders are responsible for internal financial control of their budgets (art. 158 par. 11 of the Budget Code). This control should ensure: (1) the legal, effective and efficient use of funds and (2) the use of subsidies and subventions⁵⁵ in accordance with the goals and conditions set in the relevant laws and decrees. Main budget holders are entitled to carry out inspections of subordinate budget holders and financial officers, including those of State unitary enterprises.

110. All government entities and State unitary enterprises are subject to the Russian procurement legislation (the Civil Code, the Federal Law on Procurement and some other federal laws). Joint stock companies that are (partly) financed by subsidies do not have to follow the prescribed procedures but they may on a voluntary basis (see box 7).

⁵⁴ See par. 128.

⁵⁵ See chapter 6, par. 189 for the concepts of subsidies and subventions.

Box 7. Procurement

The Federal Law on Procurement came into effect on 1 January 2006. It has created a uniform procurement process for all levels of government and defines which entities that must use the framework. It aims to improve transparency and to promote fair competition among bidders.

The two agencies that bear the main responsibility for the procurement process are the Federal Anti-monopoly Agency and the Federal Treasury

The tender process has one main threshold of 60,000 RUB. Below this value, a so called direct procurement contract can be concluded. This implies that the buyer can directly contact a supplier without public tender procedure. Above the threshold, a public tender process has to be pursued. The law outlines 4 different tender procedures and specifies criteria for their use. Complaints are directed to the Anti-monopoly Agency if criteria or tender regulations are violated. In special cases of gross violation, cases can be directed to the regular criminal courts.

111. The Russian Treasury was set up in 1992. In 2004 it became a Federal Service subordinated to the Ministry of Finance. The tasks and competences of the Treasury are regulated in the Law on the Federal Treasury of 2004. It is represented in all regions and in many local governments. All in all, it has approximately 2200 local branches and 50,000 employees.

112. The Treasury runs a Single Treasury Account for all levels of government, held at the Russian Central Bank. The coverage of the Single Treasury Account for the Federal Government has improved in recent years and now approximately 99.9 percent of federal spending (excluding State unitary enterprises) passes through the Treasury. The Single Treasury Account serves for payments in Roubles as well as in other currencies.

113. Spending units keep two sub-accounts in the Single Treasury Account, one of which is used for fee-financed expenditures and the other for all other expenditures. Spending units of sub-national governments still hold fee-financed accounts outside the Treasury account but this practice will be prohibited as from 2010.

Reallocation during budget execution

114. According to the revised Budget Code rules for reallocation during budget execution are different for discretionary and mandatory spending⁵⁶. For discretionary spending the general rule is that appropriations for each line item can be increased or decreased to up to 10 percent by the line ministry with approval of the Ministry of Finance. All spending increases must be fully offset by decreases. Furthermore, appropriations can be reallocated between line items by the line ministry as required by institutional changes without limit, provided that increases are fully offset by decreases. Finally, budget holders can reallocate between input items (see par. 106) within an appropriation without limit after approval by the line minister. Under similar rules that applied until 2008, reallocations of these kinds were very common and occurred on a daily basis throughout the federal government.

115. For mandatory spending the general rule is that appropriations can be increased by up to 5 percent if required by demand under the current entitlement law. These increases have to be offset by decreases in other appropriations or by revenue windfalls (revenues in excess of the budget estimates).

⁵⁶ In contrast to some OECD countries all mandatory spending (spending on entitlement laws) is on budget in Russia.

In general, under the revised Budget Code, revenue windfalls (excluding oil revenues⁵⁷) may be used, apart from offsetting increased entitlement spending, for the purposes of: (1) financing the deficit (substitute government borrowing); (2) repayment of government debt.

116. Reallocations exceeding the limits for reallocation as mentioned in the previous paragraphs require a supplementary budget law (see par. 98 above).

117. At present, spending units can carry over appropriations of any kind to future years without limit with approval by the Ministry of Finance. According to the Russian Ministry of Finance, there is at present a problem with under-spending. This has led to large pools of unused appropriations. It is suggested that frequent policy changes are a possible reason for this phenomenon. As from 2008, with a longer three year horizon in the budget and less volatility in line item appropriations, the Ministry of Finance believes that this problem should be overcome.

118. A certain ambiguity prevails in Russia concerning the desirable level of detail in the budget classification. On the one hand the present classification is rather detailed (with 3800 line items), but on the other hand the opportunities for reallocation during execution are large. The strong parliamentary “powers of the purse” suggested by the detailed classification, turn out to be illusory in view of actual reallocation practices. In this light the Russian authorities may consider to move to a more aggregate classification with not more than 10 programmatic line items per ministry and not more than 200 line items in total, as exist in a number of OECD countries⁵⁸. A programmatic budget classification can have advantages from the point of view of priority setting and financial management and will probably bring savings on administrative costs.

Reserve funds

119. The annual budget law includes three reserve funds: 1) The Reserve Fund of the President; 2) The Reserve Fund of the Government; and 3) The Emergency Reserve Fund of the Government. According to the Budget Code the total appropriations for the reserve funds must remain below 3 percent of total expenditure (art. 81 par. 3).

119. The Reserve Fund of the President may not exceed 1 percent of total expenditure (or 1/3rd of the maximal total for the three reserve funds), and can be used discretionally by the President through decrees. The Reserve Fund of the Government can be used for a wide range of purposes of a temporary nature, such as supporting voluntary organisations, top-level meetings and other activities listed in the annual budget law and subject to decision by the government. The Emergency Reserve Fund of the Government can be used for financial aid in case of disasters and emergencies as well as for preventive measures prior to such events, at the discretion of the government.

Cash and debt management

120. At present the Treasury does not conduct active cash- and short term debt management for the Russian government.⁵⁹ Resources under the commitment limits are made available to the sub-accounts of

⁵⁷ Under the revised Budget Code oil and gas revenues available for expenditures are limited to the fixed oil and gas transfer, so that all oil and gas revenue windfalls flow into the Oil Stabilization Fund (see box 1 in Chapter 2).

⁵⁸ For instance: Australia, France, the Netherlands, Sweden and the United Kingdom.

⁵⁹ The Ministry of Finance is responsible for long-term borrowing.

the budget holders on a quarterly basis and budget holders are free to spend these resources as they see fit. At present budget holders do not provide cash-plans to the Ministry of Finance or the Treasury. The Treasury makes cash-need forecasts on the basis of its own information, mainly the spending patterns of previous years. In the light of this information it conducts short debt management operations if the cash surplus becomes too large. According to the Treasury, under the present regime budget holders always have sufficient cash balances in their sub-accounts to meet expenditure needs. Although working properly from this point of view, the present procedure leads to large idle cash balances during extended periods of time on many sub-accounts of the Single Treasury Account.

121. The Treasury has developed a plan for the modernization of cash management. The plan is aimed at collecting better information from budget holders about the timing of their cash needs. In particular budget holders in charge of large investment projects will be required to submit cash plans. This will enable the Treasury to diminish the cash balances on sub-accounts of the Single Treasury Account and to perform a more active short term debt policy.

Service delivery

122. Russia is a federal state and many services are provided by the regions and local governments rather than by the federal government. The expenditures of sub-national government (regions and local governments) are more or less stable in terms of GDP since the year 2000 (around 14 percent of GDP) whereas the expenditures of the federal government have slightly risen⁶⁰ (from 14.1 percent in 2000 to 17.5 percent of GDP in 2007).

123. Table 7 shows total employment in the civil service by level of government. The civil service excludes the military as well as non-administrative public employment (schools, hospitals, etc.). These numbers include staff in core ministries working on policy preparation and providing support services (legal advice, financial control, ICT, etc.) other than service delivery. Sub-national government in Russia is treated in the chapter 6. The present chapter will further focus on service delivery by the federal government.

⁶⁰ Federal expenditures include transfers to sub-national government, which are counted again when they are spent. There is thus an overlap between the numbers for federal and sub-national spending.

Table 7. Employment in the civil service by level of government in 2006
(Thousands of employees)

	<i>Total employment in the civil service*</i>
Federal government	828.5
• <i>Federal level</i>	42.5
• <i>Territorial (federal entities in the regions)</i>	786.0
Regional government	241.5
Local government ⁶¹	507.2
Total	1 577.2

* The civil service includes administrative personnel employed in the general government sector; this does not include military personnel, doctors, teachers, police personnel, and other non-administrative personnel.

Source: Rosstat 2008

124. In Russia public satisfaction with the quality of public administration is very low. Ordinary Russian gives consistently bad scores to their public administration in survey research. The bureaucracy is seen as little client oriented, suffering from red tape, and sometimes corrupt (OECD 2006). These deficiencies are partly rooted in the Soviet past but also in the slow pace of administrative reform in the 1990ies.

125. Administrative reform has become a major priority since 2000. Priorities were listed in a Presidential decree of July 2003⁶². They included: (1) elimination of unnecessary functions and duplication of work, (2) the development of independent regulators for market sectors susceptible to monopolistic practices and the organisational separation of policy making, regulation and service provision.

126. Following up on the first mentioned priority, the Government Commission on Administrative Reform established under the Presidential decree of 2003, undertook a review of over 5,000 functions of federal executive branch. Based on this review, the Commission felt that 800 functions were redundant, 350 functions were of duplicative nature, and 500 functions were carried out at a too broad scale. The results of this report were brought to bear on the reorganisation of public administration that started in 2004.

127. As of March 2006 only a minor part of government functions which had been found to be excessive in the report of the Commission on Administrative Reform had been abolished or reformed. According to Annual Report on the Results of Socio-economic Development of the Ministry of Economic Development and Trade for 2004, the largest part of the excessive functions still exists⁶³. The reform process seems to have stalled in the last two years and the sense of urgency has been lacking.

⁶¹ At the local level there is not a "civil service" in the proper sense. The number in the table includes officers holding elective posts in municipal bodies (members of elective municipal bodies), nominated officials of all ranks and specialists working on the basis of a labour contract.

⁶² Source: Presidential decree N 824 of 23 July 2003 "Administrative reform: measures in 2003/2004".

⁶³ On Results of the Socio-economic Development of the Russian Federation in 2004 and Tasks for Economic Policy of the Government of the Russian Federation for 2005. Ministry for Economic Development and Trade of the Russian Federation, February 2005, p. 95.

128. Following up on the second priority in the Presidential decree of 2003, the executive branch of the federal government was reorganised in 2004⁶⁴. Federal offices were divided in three types:

1. Federal Ministries are policy-making institutions. They perform policy analysis and evaluation and are responsible for drafting new legislation. They supervise the activities of federal services and agencies within their jurisdiction.
2. Federal Services are supervisory and regulatory bodies. They can take decisions with external⁶⁵ legal consequences in individual cases but they cannot make general laws or decrees.
3. Federal Agencies are direct providers of public services to the state and/or private sector. They are often partly funded by fees charged for their services.

129. The reorganisation aimed to separate policy-making, service delivery and regulation of the market sector. The separation was supposed to reduce the risk of conflict of interest inside the executive branch of government and to improve controllability and accountability of federal executive bodies. In practice, the reorganisation was carried through in a formal sense; some federal entities were renamed as services and agencies and gained some additional managerial autonomy. However, the division of functions was only very imperfectly realised. Many services and agencies continue to make policy and many ministerial divisions are engaged in (administrative) execution rather than policy making. Furthermore there is still little indication that Russian authorities are comfortable with independent regulatory institutions, shielded from outside pressure, in order to ensure the proper functioning of markets (OECD 2006).

130. At present the executive branch of the Russian Federation consists of:

- Federal Ministries under the authority of the president and Services and Agencies under the direct or indirect⁶⁶ authority of the president (5 Ministries, some of which supervising one or more Services or Agencies.⁶⁷)
- Federal Ministries under the authority of the Government and Services and Agencies supervised by those ministries (11 Ministries, each of which supervising one or more Services and/or Agencies.⁶⁸)

⁶⁴ President's Decree Nr. 314 of 9 March 2004 "On the System and Structure of Federal Executive Authorities", revised by President's Decree Nr. 649 of 20 May 2004: "Issues of Federal Executive Authorities Structure".

⁶⁵ In relation to citizens.

⁶⁶ Direct means: under direct supervision of the President (5 Services, 2 Agencies). Indirect means: services and agencies supervised by federal ministries that are under the authority of the President (4 Services, 1 Agency).

⁶⁷ The 5 presidential ministries are: Ministry of Interior (supervises 1 service), Emergency Ministry, Ministry of Foreign Affairs, Ministry of Defence (supervises 3 services and 1 agency), Ministry of Justice. The 5 presidential Services are: Service of Communication by Courier, Service of External Investigation, Federal Security Service ("FSB"), Service of Drugs Traffic Control, Federal Protection Service. The 2 presidential Agencies are: Central Administrative Agency of Special Programs of the President, Administrative Office of the President.

⁶⁸ The 11 governmental ministries are: Ministry of Health and Social Development (supervises 3 services and 3 agencies), Ministry of Information Technologies and Communications (supervises 2 agencies), Ministry of Culture and Mass Communications (supervises 3 agencies), Ministry of Education and Science (supervises 2 services and 2 agencies), Ministry of Natural Resources (supervises 1 Service and 3 Agencies), Ministry of Industry and Energy of the Russian Federation (supervises 3 agencies), Ministry of Regional Development (supervises 1 agency), Ministry of Agriculture (supervises 1 service), Ministry of Transportation (supervises 1 service and 5 agencies), Ministry of Finance (supervises 3 services and the Treasury agency), Ministry of Economic Development and Trade (supervises 2 agencies).

- Services and Agencies and Committees under the direct authority of the Government (5 Agencies; 10 Services; 2 Committees).

131. In late 2005 the Government approved an ambitious Concept for administrative reform, to be implemented over the period 2006-2008. This document is partly inspired by the ideas of New Public Management. It puts much emphasis on performance measurement, quality standards for public services, the rights and obligations of citizens and officials concerning service provision, transparency, the autonomy of managers concerning the input mix (procurement, contracting out, recruitment) and merit pay for managers. The time scheme of the document foresees that the reforms are rolled out over the period 2006-2008 and is not realistic anymore. The measures are mostly commendable, provided that performance measurement remains to be seen as a tool for sectoral policy assessment (not as a tool for budgetary decision-making). A caveat is in order concerning merit pay, where OECD experiences are rather mixed and where in the Russian context risks for new forms of corruption are high.

132. Pensions, social insurance (against income loss due to unemployment or disability) and health insurance are largely financed and administered by three State Extra-Budgetary Funds (see chapter 1, par. 3). These funds are run on a pay-as-you go basis (benefits are not funded). Table 8 provides some data about the expenditures of the federal funds (there are also Mandatory Health Insurance Funds at the regional level).

Table 8. State Extra-Budgetary Funds
(in percent GDP)

	Provisional outcomes	Budget 2008- 2010		
	2007	2008	2009	2010
Pension Fund	5.6	6.0	6.2	6.4
Social Insurance Fund	0.9	0.9	0.8	0.8
Mandatory Health Insurance Fund	0.4	0.3	0.3	0.2
Total	7.0	7.1	7.3	7.5

Source: Federal Budget 2008-2010.

The public enterprise sector

133. The public enterprise sector at the federal level consists of federal State unitary enterprises (see however chapter 1 par. 39 and 40 for their present ambiguous position) and joint stock companies in which the Russian Federation has a stake (table 9).

Table 9. Federal State unitary enterprises and joint stock companies in which the Russian Federation has a stake (1 June 2006)

Industry	State unitary enterprises		Joint stock companies	
	Units	Percentage	Units	Percentage
Non-market goods and services	1817	25,3	356	9,6
Manufacturing industry, including	1624	22,6	1772	47,6
Machine building industry	660	9,2	663	17,8
Light industry	187	2,6	27	0,75
Building material industry	55	0,75	53	1,4
Food processing industry	55	0,75	141	3,8
Metallurgic industry	30	0,4	101	2,7
Chemistry	34	0,5	98	2,65
Other manufacturing industries	603	8,4	689	18,5
Agriculture	913	12,7	363	9,7
Construction	752	10,5	380	10,2
Transport and communications	612	8,55	396	10,6
Forestry	53	0,75	99	2,7
Other industries	1407	19,6	358	9,6
Total	7178	100.0	3724	100.0

Source: Institute of the Economy in Transition (2007)

134. Overall 411.8 thousand State unitary enterprises and joint stock companies are (partly) in or regional/municipal ownership (as of 1 July 2007). Current legislation is aimed at providing subsidies to enterprises that conduct quasi-fiscal activities by the delivery of goods and services below cost-price. The authorities of regional and local governments, providing the subsidies, have to specify procedures and criteria in their regulations. These subsidies will subsequently be compensated by federal grants. The total of subsidy grants in the federal budget for 2008 amounts to 0,2 percent of GDP (1,3 percent of the federal expenditures).

135. In case of public ownership, managers of commercial enterprises have often great difficulty in separating the roles of entrepreneur and government representative. Within the latter, the sub-roles of market regulator and fiscal authority can be distinguished. The consequence is often that none of the roles is performed properly (the enterprise does not maximize profits, engages in monopolistic practices and is not paying enough tax) to the detriment of both the enterprise and the government. Although Russia continues to pursue its privatization policy concerning small and medium sized State unitary enterprises and joint stock companies, government acquisitions concerning (very) large companies have increased in the last few years. Admittedly, it is harder to impose effective market regulation and tax laws upon large firms than small firms, but ample evidence in OECD countries shows that it is by no means impossible to design effective forms of regulation for markets in which very large players operate. Nothing suggests that government ownership is the optimal solution in these cases. In this light the Russian authorities may reconsider their privatization policies of the last few years.

Human resource management

136. The general employment and minimum wage laws of Russia are also applicable to civil servants. On top of that, civil servants, have additional protection, giving them certain benefits and guarantees. The minimum wage is established by Federal legislation. Civil servants are paid based on 5 different classes of employment based on professional group (military personnel, judicial personnel, etc.). For some of these categories allowances are established based on education, academic degrees and titles. Within each class, the wage may consist of three parts: 1) the base salary; 2) class rank allowance; and 3) fringe benefits often in kind. The wages of civil servants are set according to a scale consisting of 12 steps.

137. Civil servants are subject to a code of behaviour⁶⁹, stating rights and responsibilities. Civil servants must annually declare their assets and liabilities to the tax authorities (IMF 2004).

138. Remuneration practices are not very transparent, mainly due to in kind fringe benefits, such as housing facilities. Human resource management practices vary widely between ministries, agencies and services. While some have modernized their rules for recruitment, assessment and career development, others have not. Although central policies aimed at imposing minimum standards are being developed, thus far they have not been implemented.

Conclusions

139. Russia has successfully built up a modern Treasury organisation and brought all government expenditures and revenues on a Single Treasury Account held at the Central Bank. What remains to be done is the clarification of the situation of State unitary enterprises (which now are excluded from the Single Treasury Account) and the integration of entrepreneurial activities of sub-national government. The Ministry of Finance is confident that these tasks will be achieved at short notice.

140. Russia has introduced a modern procurement law and has created transparent procurement procedures, including possibilities for redress by appeal to an independent administrative tribunal. The data provided by the Russian authorities about the use of these procedures do not make clear how effective the procurement procedures actually are.

141. The budget classification in Russia is rather detailed. On the other hand the Budget Code grants large opportunities for reallocation during execution. The strong parliamentary “powers of the purse” suggested by the detailed classification, turn out to be illusory in view of actual reallocation practices. In this light the Russian authorities may consider to move to a more aggregate classification with not more than 10 programmatic line items per ministry and not more than 200 line items in total, as exist in a number of OECD countries. A programmatic budget classification can have advantages from the point of view of priority setting and financial management and will probably bring savings on administrative costs.

142. The Treasury has developed a plan for the modernization of cash management in 2008. The plan is aimed at collecting better information from budget holders about the timing of their cash needs. This will enable the Treasury to diminish the substantial idle cash balances on the accounts of main budget holders in the Single Treasury Account of the Federal Government and to perform a more active short term debt policy.

⁶⁹ The Public Service law (Federal law No. 119-FZ, of July 31, 1995 “On the Fundamentals of Public Service in Russian Federation” and Presidential decree No 885 of August 12, 2002, “On the Approval of General Principles of Official Behaviour for Public Servants”.

143. Administrative reform has become a major priority since 2000. Priorities included: (1) elimination of unnecessary and duplicative functions, (2) the development of independent regulators for market sectors susceptible to monopolistic practices and the organisational separation of policy making, regulation and service provision. Concerning the first priority, as of March 2006 only a minor part of unnecessary and duplicative functions identified in 2003 had been abolished or reformed. The reform process seems to have stalled in the last two years and the sense of urgency has been lacking. Concerning the second priority the Government reorganised the federal administration with a view to the separation of policy-making, service delivery and regulation of market sectors. In practice, the reorganisation was carried through in the formal sense; some federal entities were renamed and gained some additional managerial autonomy. However, the division of functions was only very imperfectly realised.

144. In late 2005 the Government approved an ambitious Concept for administrative reform, to be implemented over the period 2006-2008. The time schedule of the document foresees that the reforms are rolled out over the period 2006-2008 and is not realistic any more. The measures are mostly commendable, provided that performance measurement remains to be seen as a tool for sectoral policy assessment (not as a tool for budgetary decision-making). A caveat is in order concerning merit pay, where OECD experiences are rather mixed and where in the Russian context risks for new forms of corruption are high.

145. Russia has very large public enterprise sector. Although Russia seems to pursue its privatization policy concerning small and medium sized State unitary enterprises and joint stock companies, government acquisitions concerning (very) large companies have increased in the last few years. Although the imposition of effective market regulation upon large firms is not an easy task, OECD experience shows that it is by no means an infeasible task. Nothing suggests that government ownership is the optimal solution in these cases. In this light the Russian authorities may reconsider their privatization policies of the last few years.

146. Remuneration practices are not very transparent, mainly due to in kind fringe benefits, such as housing facilities. Although central policies aimed at imposing minimum standards for practices concerning recruitment, assessment and career development are being developed, thus far they have not been implemented.

CHAPTER 5 ACCOUNTING AND AUDITING

Accounting

147. Russia's accounting system is based on accrual accounting. Both financial and non-financial assets are covered by financial reports. During 2007 a revaluation of non-financial assets has been carried out in all sectors covered by the federal budget.⁷⁰

148. At the federal level of government accounts are made up in accounting units of ministries and Federal agencies and Services. Accounts are aggregated for the federal level at the Ministry of Finance.

149. Financial reporting is well developed. In principle, three different kinds of reports are compiled; 1) monthly reports; 2) quarterly reports; and 3) annual reports:

- The **monthly reports** on cash inflows and outflows present budget execution at a fairly aggregate level. They present realizations on a cash-flow basis using Treasury data.
- The **quarterly reports** go into more detail. They present realizations (including a report on financial results and a report on budget execution), using data from spending units which are compiled and checked against Treasury data.
- **The annual reports** use data from each spending unit, which are checked by local Treasury branches. The annual reports provide both cash and accrual information (including a balance of budget execution, a balance of cash inflows and outflows, a financial results report and a report on budget execution). In addition, there are annual reports on the execution of the State Extra-budgetary Funds.

150. The quarterly reports on federal budget execution are submitted to the government and the parliament. The annual report on federal budget execution is presented to the parliament as a draft law and voted upon. In the period 2001-2007 the State Duma received the draft law on federal budget execution (of the budgets 2000-2005) around 8 months after the end of the budget year, then received the audit report of the Chamber of Accounts on this draft law around 11.5 months after the end of the budget year, and then started to consider the draft law and the audit report around 14 months after the end of the budget year. In this period the laws on federal budget execution have been approved around 15.5 months after the end of the budget year, which was much longer than the 11 months envisaged by the Budget Code⁷¹. If the schedule foreseen by the Budget Code of 2007 will be observed from 2008 onward, the Parliament will receive the draft law on budget execution of the previous year simultaneously with the budget for the next budget year and may be able to approve the draft law within 12 months after the end of the fiscal year.

Internal audit

151. The Russian government sector has not yet a uniform internal audit system: there are no unified standards and procedures for internal audit; no legal requirement to establish internal audit departments

⁷⁰ Order 306/120n/139 of the Ministry of Economic Development and Trade, the Ministry of Finance and the Federal Service of Statistics of October 2nd 2006.

⁷¹ Similarly, the draft law on federal budget execution 2006 will probably be approved in April 2008.

in the ministries, agencies and services; no separation of internal control and audit; no specifically qualified human resources. However, since budget holders are responsible for internal control (see Chapter 4 par. 109), executive government bodies may establish internal audit units on their own initiative. An example of such an initiative is the department of internal control and audit established in 2005 within the Federal Treasury. The Federal Treasury has adopted a “Concept of internal control and audit development” which serves a guideline for the activities of the department. The department of internal control and audit is responsible to the deputy Head of the Treasury and its activities include both internal control and audit.

152. The revision of the Budget Code in 2007 has formally recognized the right of executive government bodies to create internal audit units (article 270 par. 1). The new provision is currently the only legal regulation for internal audit. It does not stipulate either the independency of internal audit units or any other important principles of internal audit as comprised in international standards. For the further development of internal audit in Russia it is important that basic standards and procedures, including the separation of audit from internal control, are inserted in the Budget Code.

153. The Federal Service of Financial and Budgetary Control and Supervision (Rosfinnadzor) is an executive governmental agency subordinated to the Ministry of Finance. Its mandate is to carry out financial inspections of governmental units at the federal and regional levels and organizations receiving budgetary funds. The Service is established in its present form in 2004 but has its roots in Soviet times (it was the Control and Revision Department of the Ministry of Finance). It is staffed with approximately 5000 officers, and has 78 regional offices all over Russia. Although the Service fulfils roles that are similar to those of internal audit units, its procedures are more based on inspections and sanctions, and less on independent, constructive advice to ministers and heads of agencies and services. Furthermore, the Service focuses on legal compliance and does not conduct performance assessments. The tasks of the Service overlap with those of the Chamber of Accounts on the one hand and those of the new internal audit units within the ministries on the other hand. When Russia wants to develop further its internal audit function within the ministries, the future role of the Federal Service of Financial and Budgetary Control should be clarified, perhaps as a much smaller internal audit unit for a few large agencies (for instance the tax service).

External Audit

154. The Chamber of Accounts of the Russian Federation is in charge of the external audit. The legal basis for the Chamber is provided by the constitution (art.101, 102, 103), by the federal Law on the Chamber of Accounts (1995), and by the Budget Code. The Chamber of Accounts has been established in 1995. The State Duma appoints and dismisses the Chairman and half of the Auditors of the Chamber of Accounts, the Council of Federation appoints and dismisses the Deputy Chairman and the other half of the Auditors.

155. According to the Law on the Chamber of Accounts, the Chamber is composed of the Chairman, the Deputy Chairman, the Auditors and the staff. The Collegium is the Chambers’ managing body. It is composed of the Chairman, the Deputy Chairman, and the Auditors, which are the heads of the specific chambers.⁷² Currently, there are twelve Auditors in the Collegium. The Collegium is responsible for drafting auditing methodology, controlling and reviewing operations, and compiling reports to the Council of Federations and the State Duma. The Chamber of Accounts has 1120 employees, including 769

⁷² Federal Law No 4-FZ of 11 January 1995 “On the Chamber of Accounts of the Russian Federation”, Par. 4-7.

staff carrying out audits on federal budget execution. Included in the latter are 556 inspectors who bear responsibility for audits (per 1 January 2007).⁷³

156. The Law on the Chamber of Accounts defines functional and organizational independence of the chamber and grants professional independence to the members of the Collegium. In addition, the law provides for procedures for dismissal. The budget of the Chamber of Accounts is presented to the parliament through the Government, as a supplement to the budget of the Government.

157. According to the Law on the Chamber of Accounts, the Chamber has seven tasks: (1) exercising control over timely execution of the budget, (2) determining the effectiveness and expediency of disbursement of state funds and use of state property, (3) evaluating the justification for income and expenditure items of the draft federal budget and federal extra-budgetary funds, (4) examining the financial consequences of draft federal laws, (5) monitoring the indicators established for the federal budget, (6) exercising control over legality and timely disbursement of federal budget resources, and (7) regularly informing the two Chambers of Parliament on the progress of budget execution. As from 2008 the Chamber of Accounts will start preparing opinions on the annual budget execution reports of the main budget holders (these opinions should be produced not later than 1 June after the end of the budget year). The mandate for these opinions is the amended Budget Code of 2007. The Chamber of Accounts audits the annual report on federal budget execution but it does not audit the annual report on financial results (including the budget balance).

158. The Chamber of Accounts exerts its powers over the entire federal government (including State Unitary Enterprises) of the Russian Federation as well as the extra-budgetary funds. In addition the Chamber of Accounts audits those regional governments, which receive at least 60% of financing from the federal budget.

159. The annual plan of audit is subject to approval by the Collegium of the Chamber of Accounts. Approximately 20% of the planned activities under the audit plan of the Chamber of Accounts are obligatory audits. Other audits include those initiated by the Chamber itself, but also the Government and the President can propose audits to the annual audit plan.

160. There are special Audit Authorities in charge of auditing sub-national governments, such as the recently created Regional Chambers of Accounts. The federal Chamber of Accounts cooperates with the regional Chambers within the Association of control and accounts bodies of the Russian Federation.

161. The largest part of the work of the Chamber of Accounts is devoted to financial audit. This work is carried out by some 300 employees. Compliance checks and budget advice are the second largest task (400 employees). At present only a small part of the work is devoted to auditing performance. It is expected that the importance of performance audits will increase in the coming years. Until now there is no legal mandate for performance audits in the Budget Code.

162. There seems to be considerable overlap with the government's audit activities, notably with the activities of the Federal Service of Financial and Budgetary Control and Supervision. This agency is subordinated to the Ministry of Finance and thus seen by the line ministries as an external supervisory authority and not as an internal advisory unit.

⁷³ Source: annual report of the Chamber of Accounts 2006.

163. The Chamber of Accounts reports primarily to Parliament. The Parliament receives: (1) the audit reports with the ex-post opinion of the Chamber of Accounts on the government's reports on budget execution and on execution of the extra-budgetary funds in the previous budget year; (2) reports on the status of budget execution in the current year (on the basis of own data of the Chamber of Accounts; the Chamber does not give opinions on the government's quarterly reports on budget execution); (3) the ex-ante opinion on the draft budget law, including assessments of the economic forecasts of the Government (GDP, inflation, oil-price, etc.); (4) the annual report of the Chamber of Accounts (on its own activities).

164. There are no committees in the Chambers of Parliament dedicated exclusively to the consideration of the opinions of the Chamber of Accounts, but some committees are dealing with its opinions together with other issues. The previous State Duma (4th convocation) had a Committee on Budget and Taxes⁷⁴ within which there was a Subcommittee on Financial Control, Accounting, Audit and Interaction with the Chamber of Accounts (consisting of 5 members). The composition of the Committee on Budget and Taxes of the present Duma (5th convocation) is not announced yet. The Council of the Federation has a Committee on Budget (consisting of 19 members) and a separate Committee on Interaction with the Chamber of Accounts. Neither the Committee on Budget and Taxes of the State Duma, nor its Subcommittee on Financial Control, Accounting, Audit and Interaction with the Chamber of Accounts, considers the opinions of the Chamber of Accounts in detail or holds hearings about them. When the Council of the Federation considers the draft law on federal budget execution with the enclosed opinion of the Chamber of Accounts, the main responsible committee is the Committee on Budget. The Committee on Interaction with the Chamber of Accounts can give its opinion on an equal footing with other (sectoral) committees of the Council of the Federation to the Committee on Budget. The Committee on Interaction with the Chamber of Accounts does not hold hearings on the audit results of the Chamber of Accounts. The only parliamentary hearing concerning the budget is the above mentioned hearing in mid-September⁷⁵ of the Council of the Federation on the draft federal budget law for the upcoming fiscal year, which is carried out by its Committee on the Budget.

165. For the effectiveness of the work of the Chamber of Accounts it is important that both the State Duma and the Council of the Federation establish strong procedures for follow up on the findings of the Chamber. This would have to include explicit recognition of the right of the parliamentary Committees on Interaction with the Chamber of Accounts to hold public hearings in which responsible ministers are invited and to propose amendments of the draft law on budget execution to make visible the inappropriate use of budgetary funds and to propose changes in legislation to avert future misuse of funds.

166. Whenever audits of the Chamber of Accounts reveal serious wrongdoings, the Chamber can also submit reports to the judiciary or to the government. Regarding serious criminal cases, the Chamber of Accounts may be requested to report directly to the President. The number of these special reports does not exceed five per year.

Conclusions

167. Financial reporting is well-developed. Monthly, quarterly and annual reports provide a comprehensive insight in the progress of budget execution. The revised Budget Code of 2007 foresees a

⁷⁴ See chapter 3 par. 89;

⁷⁵ See chapter 3 par. 93.

tighter time schedule for the annual report (draft law on federal budget execution) which will make it possible that the Parliament approves the draft law henceforth within 12 months after the end of the fiscal year.

168. The Russian government sector has not yet a uniform internal audit system. The revised Budget Code of 2007 has formally recognised the right of governmental bodies to create internal audit units, but thus far only a limited numbers of ministries, agencies and services have done so.

169. The tasks of the Federal Service of Financial and Budgetary Control and Supervision overlap with those of the Chamber of Accounts on the one hand and the new internal audit units within the ministries on the other hand. When Russia wants to develop further its internal audit function within the ministries, the future role of the Federal Service of Financial and Budgetary Control should be clarified, perhaps as a much smaller internal audit unit for a few large agencies (for instance the tax service).

170. The Federal Law on the Chamber of Accounts of the Russian Federation has created a modern and comprehensive system of external audit. Thus far the Chamber of Accounts has focused on financial and compliance audits, but it intends to develop its capacity and work on performance audits in the coming years. It is important that the Budget Code be amended to explicitly recognise its mandate in this area.

171. There are no committees in the Chambers of Parliament dedicated exclusively to the consideration of the opinions of the Chamber of Accounts on the Government's reports on federal budget execution, but some committees are dealing with opinions together with other issues. Neither the Subcommittee on Financial Control, Accounting, Audit and Interaction with the Chamber of Accounts of the State Duma nor the Committee on Interaction with the Chamber of Accounts of the Council of the Federation holds hearings on the opinions of the Chamber of Accounts. For the effectiveness of the work of the Chamber of Accounts it is important that both the State Duma and the Council of the Federation establish strong procedures for giving follow up to the findings of the Chamber. This would have to include public hearings in which responsible ministers are invited and an explicit recognition of the right of parliamentary Committees on Interaction with the Chamber of Accounts to propose amendments of the draft law on budget execution that would regularize inappropriate use of budgetary funds and to propose changes in legislation to avert future misuse of funds.

CHAPTER 6 FINANCIAL RELATIONS BETWEEN LEVELS OF GOVERNMENT

Federal structure of Russia

172. Russia is a federal state with a three-tier governmental structure: the federation, the regional level and the local level.

173. The regional layer consists at present of 85 Subjects of the Federation (regions). They are of six types: 21 republics, 47 oblasts, 1 autonomous oblast, 8 krajs, 6 autonomous okrugs and 2 Cities of Federal Significance (Moscow and Saint Petersburg). The identity of Republics and autonomous okrugs is based on ethnicity. The distinction between the various types of regions has little practical significance. Due to a policy of amalgamation pursued by the government in recent years, the number of regions is being reduced from 89 in 2005 to a planned 84 in 2008. According to the Constitution the Subjects of the Federation have equal rights in their relations to federal authorities (art. 5.1 and 5.4). The size of the regions varies considerably. In terms of territory: from 1.081 km² (Moscow) to 3.103.200 km² (Sakha Republic), and in terms of population: from 42.000 (Nenets Autonomous Okrug) to 10.358.000 (Moscow).

174. Each Subject of the Federation possesses its own foundation laws (constitutions for the republics and charters for all others), political institutions and legislation.

175. In recent years, significant progress has been made towards greater consistency between the regional and federal legal systems and a more unified economic and security space across the federation. Most of the bilateral "treaties" between the federation and the regions concluded in the beginning nineties have now been rescinded, and regional legislation is gradually being brought into line with the Constitution and the federal laws.

176. The lowest governmental level is the local level (or local self-government level). Local governments are established to govern urban and rural settlements and other territories mindful of historical and other local traditions.

177. Reformed in 2003, governmental bodies at the local level remain relatively new and untested. The federal Law on local self-government was enacted in October 2003. It seeks to establish a uniform and universal system of local government throughout the country. The full implementation has been postponed until 2009. The law calls for the creation of a two-tiered system, composed of upper level municipalities dealing directly with the regional level (municipal districts and urban okrugs) and lower level municipalities with no direct relation with the regional level (urban and rural settlements within municipal districts). There is a specific type of municipalities for Moscow and St. Petersburg (Cities of Federal Significance) called intra-city territory (see box 7).

Box 7. Types of municipalities

According to the 2003 Federal Law on local self-government, the types of municipalities are:

Upper level

Municipal district, a group of municipal settlements (often along with the inter-settlement territories, i.e. territories located outside the territories of municipal settlements) having common territory within which local self-government is carried out. Its bodies may exercise some state powers conferred on them by the federal and regional laws. In practice, municipal districts are usually formed within boundaries of existing administrative districts of the regions (rayons).

Municipal urban okrug, a municipal urban settlement not incorporated into a municipal district, where local self-government is carried out. Its bodies may exercise some state powers conferred on them by the federal or regional laws.

Intra-city territory of a federal city, a part of a federal city's territory where local self-government is carried out.

Lower level

Municipal urban settlement, a city/town or an urban-type settlement where local self-government is carried out directly by the populace and/or via local self-government bodies which are elected or selected by other means.

Municipal rural settlement, one or several rural localities where local self-government is carried out directly by the populace and/or via local self-government bodies which are elected or selected by other means.

Source: 2003 Federal Law on local self-government

178. As of April 1, 2006 there are 24,196 municipalities in the Russian Federation. The most numerous type of municipality is rural settlement (82.0%), followed by urban settlements and municipal districts (7.4%) and municipal urban okrugs (2.2%). The number and weight of other types of municipalities cannot be estimated until the law of 2003 has been fully implemented throughout the country.

Reform of sub-national finances

179. In 2004 the sub-national finances of Russia have been radically reformed and put on a modern footing. The revision of the Budget Code of 2004 laid down the basic principles, including sub-national fiscal rules. The federal Law on the distribution of assignments between levels of government of 2004 substantially changed the division of tasks between the federal, regional and local level of government and brought more consistency in the delineation of spending mandates. At the revenue side the main sources of funding were identified. These consists of own taxes, shared federal taxes and transfers from the federation and, for local governments, transfers from the regions. Unfunded spending mandates, which were characteristic for the previous situation, can no longer occur. Simultaneously, Russia has started a new policy aimed at strengthening sub-national fiscal autonomy, and reduction of the share of federal grants in sub national revenue.

Sub-national expenditures

180. Clear assignment of spending mandates is necessary for the attribution of tax bases and grants. Competences of each level of government are now set out in the Russian Constitution, in the Law on the general principles of organisation of legislative and executive state bodies of RF Subjects, in the Law on local self-government and in a some other federal laws. Table 10 provides an overview of the distribution of the functional expenditures of general government over the levels of government.

Table 10. Distribution of functional expenditure over levels of government
(in percent of total functional expenditure ⁷⁶)

Functions	Federal level	Regional level	Municipal level
Judicial system	89	11	0
Foreign relations and international cooperation	97	3	0
Basic research	99	1	0
National defence	100	0	0
National security and law enforcement	77	20	3
Bodies of internal affairs	62	33	5
Fire safety	33	62	5
National economy	36	56	8
Space activities	100	0	0
Recreation of mineral resources; water resources and forestry	89	11	0
Agriculture and fishing	24	70	6
Transportation	32	59	9
Housing and procurement of household supplies ⁷⁷	9	49	42
Environment protection	29	56	15
Primary education	22	26	52
Pre-school education, secondary education, basic professional education, youth politics and children health	1	21	78
Higher professional education	95	5	0
Culture, media and film-making	29	39	32
Press editing	11	65	24
Healthcare and sport	14	68	18
Social policies	81	14	5
Pensions	100	0	0
Social services to the population	7	81	12
Orphanages	1	24	75

Source: Treasury reports

⁷⁶ For the federal level inclusive of the expenditures of extra-budgetary funds.

⁷⁷ Electricity, heat, gas and water supply and sewerage.

181. The Law on local self-government of 2003 contains a binding list of spending mandates of municipalities. The law has led to a substantial decentralization from the regions to the municipalities. Municipalities have become responsible for development and support of health resorts of local importance, organization and implementation of civil protection against natural and technological disasters, maintenance and managing of rescue services and other tasks. The law stipulates that new mandates can only be transferred if adequate funding is provided by higher or levels of government or if the tax base of the municipality is extended. In practice this has often led to additional higher level regulations that unnecessarily constrain the municipal autonomy and negatively affect the efficiency of service provision.

Sub-national revenues

182. Regional and municipal revenue comes mainly from federal grants and tax sharing. Depending on region, either grants or tax shares constitute the largest share of revenues. Regional and local taxes constitute a less significant part of tax revenue. The smallest part comes from non-tax revenues: charges for usage of regional/municipal property; fines, confiscations and other financial sanctions, and from entrepreneurial activities. The weighted average revenue structure of a consolidated regional budget (including revenues of the municipalities on the regional territory) is shown in the table 11.

Table 11. Weighted average revenue structure of consolidated regional budgets (*)
(in percent of total revenues)

	2002	2003	2004	2005	2006
Tax revenues	67,4	69,5	74,4	74,1	72,2
Non-tax revenues	6,9	8,1	8,3	5,7	5,6
Grants	16,0	14,8	9,0	14,7	15,9
Income from entrepreneurial and other income generating activities	0,8	0,9	1,3	1,9	2,1
Other	8,9	6,7	7,1	3,6	4,2
Total	100	100	100	100	100

(*) 2005-2006 data are not fully comparable with prior years due to changes made in the revenue classification and changes in local government structure.

Source: Ministry of Finance (2007).

183. The picture at the municipal level is roughly similar to that at the regional level⁷⁸. Municipal revenue comes mainly from tax shares (40 percent) and grants. The share of grants (both regional and federal) in local revenues varies from about 30% to 80%. The largest part of municipal grant revenues comes from the regions. Regional grants are often regulated by federal legislation, for instance, equalisation grants should be based on per capita fiscal capacities. The share of own municipal taxes is just of a few percent.

⁷⁸ Table 11 shows the revenue structure of consolidated regional revenues in which local revenues are included. The resulting picture is largely determined by the regional revenues which are much larger than the local revenues.

184. All taxes, regardless of whether they are federal, regional or local are based on federal legislation. Within this federal framework regional and local governments have certain autonomy within constraints set by federal legislation concerning the rate structure, payment dates, exemptions in regional and local taxation. They can also remove own taxes. Box 8 shows the distribution of tax authority among levels of government. Of all general government tax revenues in 2006, 57 percent went to the federal budget and 43 percent went to regional and local governments⁷⁹.

Box 8. Distribution of tax authority under art. 12 of the Tax Code

Federal taxes and fees:

1. Value-added tax;
2. Excises;
3. Personal income;
4. Single Social tax;
5. Corporate profit tax (the rate is 24% of which 6.5% goes to the federal budget and 17.5% goes to the regional budget. Regions are allowed to reduce its rate of 17.5% for certain categories of taxpayers but not lower than to 13.5%).
6. Tax on extraction of minerals;
7. Water tax;
8. Fee for using the objects of fauna and of water biological resources;
9. State tax (fees).

Regional taxes:

1. Corporate tax on property (the federal Tax Code sets the ceiling of the tax rate and certain tax exemptions);
2. Gaming tax (the federal Tax Code sets the floor and the ceiling of the tax rate);
3. Transport tax (the federal Tax Code sets the floor and the ceiling of the tax rate).

Municipal taxes:

1. Land tax (the federal Tax Code sets the ceiling of the tax rate and certain tax exemptions);
2. Personal tax on property (the federal law on personal tax on property sets the floor and the ceiling of the tax rate).

185. Regional and local taxes go entirely to the regions or municipalities, while federal taxes go to different levels depending on the tax-sharing arrangement set in the federal legislation (the Budget Code). Regions may share their tax revenues with local government by establishing their own regional tax sharing system. Municipal districts may do the same vis-à-vis municipal settlements. Table 12 provides an overview of the federal tax sharing arrangements.

⁷⁹ Source: Ministry of Finance of the Russian Federation

Table 12. Tax shares of major taxes as established by the Budget code

	Federal Budget	Regional Budgets	Municipal budgets		
			Settlement	Municipal districts	Urban okrugs
			Tax Sharing Rates (%)		
Federal taxes and fees; taxes levied under special tax regimes					
Corporate profit tax levied at the rates established for the Federal and regional budgets respectively	Rate 6,5% 100% ⁸⁰	Rate 17,5% 100%	-	-	-
Corporate profit tax (levied on income of foreign institutions, dividends and interest accruing to state and municipal bonds – withholding tax)	100%	-	-	-	-
Personal income tax	-	70% ⁸¹	10 %	20%	30 %
Personal income tax levied in inter-settlement territories	-	-	-	30%	-
Corporate profit tax levied under production sharing agreements	20 %	80%	-	-	-
Value Added Tax	100%	-	-	-	-
Excises on ethyl alcohol made of food raw materials; excises on alcohol-containing products	50%	50%	-	-	-
Excises on ethyl alcohol made of any type of raw materials other than food	100 %	-	-		-
Excises on alcohol products	-	100 %	-	-	-
Excises on beer	-	100 %	-	-	-
Excises on tobacco products	100 %	-	-	-	-
Excises on motor gasoline, straight-run gasoline, diesel fuel, engine oils for diesel and carburetor (injection) engines	40 %	60%	-	-	-
Excises on passenger cars and motorcycles	100 %	-	-	-	-
Excises on excisable goods and products imported to Russia	100 %	-	-	-	-
Tax on extraction of minerals in the form of hydrocarbons (natural fire gas)	100%	-	-	-	-

⁸⁰ A company-subject to the corporate profit tax pays the tax by the total rate 24% of its profits, of which 6.5% goes to the federal budget and 17.5% goes to the regional budget.

⁸¹ Regions are obliged to set the share of the tax to be transferred to local budgets which should be not less than 10% of tax incomes received by the consolidated regional budget from the personal income tax (art. 58(3) of the Budget Code)

Table 12 .../...	Federal Budget	Regional Budgets	Municipal budgets		
			Settlement	Municipal districts	Urban okrugs
			Tax Sharing Rates (%)		
Tax on extraction of minerals (other than minerals in the form of hydrocarbons, natural diamonds and prevailing minerals)	40 %	60 %	-	-	-
Tax on extraction of minerals from Russia's continental shelf	100 %	-	-	-	-
Diamond extraction tax	-	100 %	-	-	-
Regular payments for extraction of minerals (royalty) under production sharing agreements concerning production of hydrocarbons (other than natural fire gas)	95 %	5%	-	-	-
Fee for the use of water biological resources (except for inland water facilities)	70 %	30%	-	-	-
Fee for the use of fauna	-	100%	-	-	-
Water Tax	100 %	-	-	-	-
Single Social Tax at the rate established by the Russian Tax Code for the federal budget	100 %	-	-	-	-
Tax levied under a simplified taxation system (franchise tax)	-	90 %	-	-	-
Tax levied in the form of patent value under a simplified taxation system	-	90 %	-	-	-
Single agricultural tax		30%	30%	30%	
Single tax on imputed income from certain types of activities				90 %	90 %
Single agricultural tax levied in inter-settlement territories				60 %	60 %
Regional taxes		100 %*			
Corporate Property Tax		100 %			
Tax on Gambling Business		100 %			
Transport tax		100 %			
Local taxes				100 %*	100 %*
Land Tax	-	-	100 %		100 %
Land Tax levied in inter-settlement territories				100 %	

* Regional taxes and local taxes may have their own tax-sharing arrangement.

Source: Ministry of Finance 2007

Fiscal rules for sub-national governments

186. The Budget Code establishes strict limits on the deficit, total annual borrowing, debt and expenditures on public debt servicing of sub-national government. For regions and municipalities debt shouldn't exceed approved total annual own budget revenue (exclusive of approved grants), and the deficit shouldn't exceed 15 percent of approved total annual own budget revenue. For regions and municipalities that have received federal (and regional) grants exceeding 60 percent (regions) or 70 percent (municipalities) of their own budget revenues (excluding subventions⁸²) during two of the last three fiscal years, the allowed debt is reduced by 50 percent of annual own budget revenues and the allowed deficit shouldn't exceed 10 percent of approved total annual own budget revenue (regions) or 5 percent (municipalities). Spending on debt servicing for both regions and municipalities should not exceed 15 percent of the total annual budget expenditure, exclusive of expenditures financed by subventions.

187. The federal Ministry of Finance carefully monitors the debt and deficit parameters of regional governments. Breaching the limits triggers sanctions, for instance, suspension of intergovernmental grants (other than subventions) until the limits are again respected.

188. If in the last reporting year not fulfilled commitments of a region or municipality exceeded 30 percent of own budget revenues, a court may appoint an external financial administrator with far reaching competences in order to restore the solvency of the government in question.

Grants

189. There are mainly three types of grants⁸³: (1) equalisation grants (non-earmarked, see the next chapter), (2) subsidies (earmarked, either matching or non-matching) and (3) subventions (earmarked for financing delegated functions and federal mandates). Federal equalisation grants, subsidies and subventions to regions and municipalities account for 40, 34 and 18 percent of total federal transfers respectively. Table 13 provides an overview of federal transfers in the budget 2008-2010.

⁸² See the next section on the concept of subventions.

⁸³ Art.129 of the Budget Code

Table 13. Federal budget intergovernmental transfers in 2008-2010
(percent of GDP)

	2008	2009	2010
Intergovernmental transfers total, including:	6,54	6,14	6,12
Intergovernmental transfers to consolidated regional budgets total, including:	2,66	2,30	1,98
Equalisation grants total, including:	1,08	0,99	0,92
Fund for Financial Support of Regions (FFSR)	0,94	0,89	0,84
Subsidies, total, including:	0,91	0,76	0,54
Co-financing of capital development	0,33	0,25	0,16
Co-financing Fund	0,56	0,47	0,38
Subventions (Compensation Fund)	0,47	0,45	0,43
Other intergovernmental transfers	0,20	0,10	0,10
Intergovernmental transfers to state extra-budgetary funds	3,89	3,84	4,14

Source: Ministry of Finance (2007)

190. The criteria for the distribution of grants are defined in the legislation. Grants to regions are mainly formula-based. Non-earmarked equalisation grants are mostly given from the Fund for Financial Support of Regions (see next section). Earmarked grants are primarily provided as subsidies from the Co-financing Fund and subventions from the Compensation Fund. The Co-financing Fund was created for matching of social expenditures in regions/municipalities (social protection of labour veterans⁸⁴, payment of family allowances, housing subsidies, etc.). It also covers federal programs for regional socio-economic development. The Compensation Fund was created for financing federal mandates at regional/municipal level. It covers expenditures for public housing services and household supplies (electricity, gas, heating, water, etc.) of Second World War veterans and disabled people. The Compensation Fund was expanded by 2.2 percent in real terms in 2006. There are also some funds for earmarked regional development aid (not specified in table 10): the Fund of Regional Development (for infrastructure, school and hospital construction, etc.) and the Fund of regional and municipal finance reform. The latter allocates resources to sub-national budget reform on competitive basis and is managed by the Ministry of Finance.

191. Beginning with the reforms of 2004 Russia has started a policy aimed at strengthening sub-national fiscal autonomy. One of the objectives of this policy is the reduction of the share of federal grants in consolidated regional revenues without shrinking the total amount of federal grants and without increasing regional and local tax bases and shares in federal taxes. This can be realized by fostering the growth of own sub-national revenues (non-tax revenue, rate increase of own taxes under the ceiling set in federal legislation) and better fiscal discipline. To promote the reform, a new article was introduced into the Budget code (art. 130). The new clause sets up conditions and in some cases sanctions restricting regional budget policies. These restrictions aim to encourage regions to develop their own tax base and to improve fiscal discipline. The article distinguishes various categories of regions on the basis of the share of grants in their budget revenues. Regions with a share of grants exceeding 60 percent (excluding subventions) are subject to the most important restrictions. These regions should: (1) conclude an

⁸⁴ Labour veteran is a person, usually of retirement age, distinguished by the state (in the Soviet era) for his/her special professional achievements.

agreement with the Finance Ministry of the Russian Federation on how to increase the efficiency of the budget expenditures; (2) open and run special accounts in the units of the Federal treasury for their transactions; (3) ask once a year for an external audit of annual reports on budget execution to be carried out by the Chamber of Accounts of the Russian Federation or by the Federal Service of Fiscal and Budget Supervision, and (4) take some other measures set by the federal legislation. The problem that this policy attempts to address is well-known. OECD countries have encountered the same problem. The Russian policy relies strongly on regulatory intervention. The Russian authorities may consider to build in more financial incentives, for instance by moving away from earmarked grants (that stimulate both federal and regional authorities to shift spending patterns in the direction of subsidized services) towards non-earmarked grants and to provide larger tax bases or tax shares to regional and local governments.

Equalisation

192. The tax and service capacities of the Russian regions vary widely. Differences in population size, mineral reserves, industrial development and per capita income create a considerable gap between rich and poor regions. Currently only around 15 of 85 regions do not get equalisation grants. As the minister of regional development D. Kozak stated recently, average GDP per capita differs by a factor 35, the level of unemployment by a factor 29 and the level of investments by a factor 158 between the richest and the poorest regions. Hence the need for equalization is obvious in Russia.

193. The main equalization instrument is the Fund for Financial Support of Regions. Originally (in 1995) the size of the Fund was calculated as a percentage of the revenues of the Value Added Tax, and later as a percentage of total federal tax receipts. The methodology started to change substantially since 2001 and currently the total equalization grant pool depends on the regional entitlements calculated under the new equalisations rules.

194. The general formula used to distribute equalization transfers was developed by the Ministry of Finance and has been repeatedly modified with the purpose to make it more objective and transparent. The grant distribution methodology is based on the following principles:

- The use of official statistics independent from the federal Ministry of Finance and from regional governments.
- The assessment of regional revenue capacity is based on their tax capacity.
- The assessment of regional service capacity is based on the number of public service users and the costs of public services.

195. When calculating transfers the government takes into account consolidated revenues and expenditures of a region (including municipal revenues and expenditures in its jurisdiction). In order to select regions eligible for an equalization grant, a special indicator measuring fiscal and service capacity of a region is calculated.

196. The Fund is allocated in three steps. First, an amount is allocated to the poorest regions, whose capacity indicator is below 60 percent of the national average. The grant narrows the gap between the capacity indicators of the regions concerned and the 60 percent threshold by 85 percent. At the second stage, each region whose capacity indicator is below the national average receives an amount which reduces the distance from the national average by a certain percentage uniform for all recipient regions. At the third stage the regions whose equalization grants decreased compared to the previous year receive a bonus. Regions whose grants grew over 7 percent compared to the previous year are penalized.

The size of the bonus depends on the efficiency of fiscal management (the efficiency measures are: tax revenue growth above the Russian average level; debt reduction above the average reduction rate for all regions; the size of the debt relative to total revenues of a region compared with the Russian average). The sum of penalties is equal to the sum of bonuses and is distributed among regions in proportion to the change in the equalization grant.

197. The formula for the equalization grant is transparent and greatly differs from the previous practice when equalization transfers were bilaterally negotiated between regional and federal governments. Moreover the methodology seems to combine two important requirements: first, providing equal service levels at equal tax costs and second, to stimulate convergence in tax and service capacity. However, the methodology has only recently been introduced and its effect on the longer term remains to be seen.

198. In recent years the share of the grants from the equalization fund in regional revenue has been shrinking. From 2005 to 2007 it fell from 38,9 percent to 33,2 percent. This does not mean that the amount of equalization grants was falling, but that that these grants have been growing at a slower pace than other grants. The real problem concerning grant dependency in Russia does not lie in the equalization grants but in other, mostly earmarked, grants.

199. At the regional level fair and transparent equalization policies for local governments are still largely lacking. An important problem is the lack of good statistical data about local tax bases and service needs. This may result in simple distribution formulas that are not always fair and efficient. Moreover it may lead to highly discretionary policies to correct undesired results. Regions may choose to allocate grants from a regional pool to all municipalities directly or use a two-step procedure by equalizing municipal districts and urban okrugs from the regional pool and then let districts equalise settlements. The second approach is the most common as it involves less effort from the regional level.

Conclusions

200. In 2004 the sub-national finances of Russia have been radically reformed and put on a a modern footing. The revision of the Budget Code of 2004 laid down the basic principles, including sub-national fiscal rules. The federal Law on widening of authorities of the RF Subjects and municipalities of 2004 substantially changed the division of tasks between the federal, regional and local level of government and brought more consistency in the delineation of spending mandates. Simultaneously, Russia has started a new policy aimed at strengthening sub-national fiscal autonomy, and reduction of the share of federal grants in sub national revenue.

201. The decentralization of spending mandates in Russia is relatively large: responsibilities in the social domain are mainly transferred to the regional and local levels; regions and municipalities are free to set standards for service provision within a federal framework; regions set their own wages for public employees. On the other hand fiscal autonomy at the revenue side has lagged behind the decentralisation of spending mandates. This has led to a discrepancy between fiscal autonomy and spending mandates, which has to be bridged by federal grants. This situation is not unique to Russia but is increasingly characteristic for many OECD countries.

202. The Law on local self-government of 2003 has reformed the structure of local government on a uniform basis throughout the Russian territory and has clarified the distribution of spending mandates over regions, upper level municipalities and lower level municipalities. The implementation of this law has taken longer than expected and is not yet fully completed.

203. Tax-shares are the most important source of tax revenue for regions and municipalities. However, this source of sub-national revenue has in recent years been rather volatile due to frequent changes in sharing arrangements and annual renegotiations (OECD 2004). It is expected that the introduction of three year budgets in the Budget Code revision of 2007 will bring more stability in this respect and will enable sub-national government to engage in fiscal planning on the medium term.

204. The federal government is unwilling to increase the size of sub-national tax bases and shares in federal taxes. This has made sub-national governments increasingly dependent on federal grants. Recent federal policy aims to counter this trend by actively promoting sub-national budgetary discipline and methods of result oriented budgeting. This policy relies strongly on regulatory intervention. The Russian authorities may consider to build in more financial incentives, for instance by moving away from earmarked grants (that stimulate both federal and regional authorities to shift spending patterns in the direction of subsidized services) towards non-earmarked grants and to provide larger tax bases or tax shares to regional and local governments.

205. Following the revision of the Budget Code in 2004 Russia has introduced a modern system of equalization based on indicators for tax and service capacity. The system is designed to bridge the great disparity in prosperity of the Russian regions. Equalisation grants are the main instrument of fiscal equalisation and their share in the total amount of federal grants is very large. One of the features of the system is that it contains financial incentives for regions to develop their own tax base (under the ceiling set in federal legislation) and thus to reduce the role of equalisation grants in their budgets. The system is transparent but rather complicated, especially as far as the financial incentives for tax base development are concerned. The effects of these incentives in the longer term remain to be seen.

206. At the regional level fair and transparent equalization policies are still largely lacking. An important problem is the lack of good statistical data about local tax bases and service needs.

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