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INTERGOVERNMENTAL FISCAL RELATIONS IN RUSSIA

FINAL REPORT

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FOREWORD

The objectives of this work are to advise the Russian government on strategies for working out the redesign of its system of financial relations among federal and oblast level governments, and to describe a program of technical assistance that would support the continuation of its work on this issue. In carrying out these objectives, we hope to have advanced the efforts of the World Bank in its 1992 study of intergovernmental fiscal relations in Russia. Professor Jorge Martinez, Charles McLure, and I all were heavily involved in the World Bank work, and we have tried to assure that this effort begins where that one left off.

Some new and important subjects are addressed in this analysis (*e.g.*, budgeting, enterprise provision of social services, fiscal information systems, property taxation) and some old subjects have been more fully developed (expenditure assignment). Throughout this work, we have benefitted greatly from detailed discussion with Russian officials, at all levels of government. This report draws on new field work in Moscow Oblast and in Chelyabinsk Oblast and at the federal level, carried out in March and June of 1993.

The report is organized with a summary and conclusions, and an overview of the technical assistance recommendations in Section I. The remaining eight sections are the full reports on each of the subjects covered. There is necessarily some overlap in the eight sections, and all authors do not agree on every point, but this is to be expected in any study of intergovernmental fiscal relations. I edited the full report and wrote the first section, and am responsible for the conclusions and recommendations reported here.

The team received the best of support in Russia, from both Russian government officials and from USAID officials. Briefings were provided to USAID/Moscow on both trips.

Roy Bahl
Chief of Party

INTERGOVERNMENTAL FISCAL RELATIONS IN RUSSIA

EXECUTIVE SUMMARY

Intergovernmental fiscal relations, the division of financing and expenditure responsibilities among the different levels of government, is a key policy issue to be addressed in the restructuring of the Russian economy. The central question is the extent to which Russia will be a decentralized federalism, like the United States, or face a more centrally controlled system of governance and finances. The pulls toward stronger local governance are strong, but there are many variants of fiscal decentralization to be considered, and a host of implementation issues to be resolved no matter what variant is chosen.

PROBLEMS AND ISSUES RELATED TO THE STRUCTURE OF THE SYSTEM

Russia today is in a transition period -- somewhere between a centralized and a decentralized system -- and neither the President nor the Parliament has decided on the kind of permanent system that should emerge. The direction of thinking seems to be toward some form of tax assignment financing system, and more budget autonomy for subnational governments. But there is not yet a concrete plan for reform of the intergovernmental fiscal system.

The resulting drift in policy is having uncertain effects on the economy, negative effects on the efficiency with which the fiscal system is administered, and is eroding confidence in federal policy making in this area. At present, the size of local budgets, tax retention shares, and the allocation of subventions are all more or less negotiated. This has led to a number of problems:

1. There does not appear to be a correspondence between the amount of revenues assigned to the subnational level of government and the amounts they need to meet their expenditure responsibilities.
2. Subnational governments do not have very much fiscal autonomy, and this may lead to inadequate accountability of locally elected officials, an inadequate rate of revenue mobilization, and an inadequate identification of local populations with the governance process.
3. Expenditure assignments to the various levels of government is unclear.
4. The present system of shared taxes and subventions is frequently changed and is not equalizing.
5. The tax administration system is deficient and there is not full compliance with the existing tax laws.
6. Many large state enterprises provide a range of social services to their employees and to others in their communities. The responsibility for these social services is now to be transferred to subnational governments, and this will have significant (but unknown) financial implications for these governments.
7. Oblast level governments face a number of problems in managing their finances, and these must be addressed in the design of any new intergovernmental fiscal system.
 - There are wide variations in economic well-being and in fiscal capacity within each oblast, and this calls for an equalization scheme of some form.
 - The information system and analytic capabilities available at the oblast level does not enable officials to do a thorough analysis of the impacts of any particular revenue sharing or subvention proposal.
 - Local governments face budget uncertainty because the revenue-sharing system is changed so frequently, and because of the delays in budget approval.
 - Local voters and officials have too little say in the formation of the budget, and on the level and mix of taxation.
8. The property tax is levied at very low rates, its structure is not appropriate for the Russian economy of the future, and its administration is in need of a major upgrade.

PROBLEMS AND ISSUES RELATED TO FISCAL PLANNING AND MANAGEMENT

The information system is deficient in that it does not provide adequate data for the federal or oblast governments to evaluate the impacts of fiscal changes. This holds true for analysis of tax policy, expenditure assignment and revenue sharing decisions. Nor are there adequate models in place to use these data for fiscal impact analysis or for forecasting.

Budget preparation, execution and review is another problem area:

- The budget process is top down; therefore, federal budget officials do not make best use of the ideas and experience of budget officials at the lower levels of the intergovernmental system.
- Numerous budget reports are prepared but their utility is more for tracking cash-flow than for planning and program evaluation.
- The value of the budget reporting system is hampered by an inadequate level of computerization.
- Employee utilization, morale and training are in need of upgrading.
- There exists no sustained and coherent capital budgeting policy.

PROPOSED TECHNICAL ASSISTANCE

The objective of this technical assistance is to support the Russian government in its efforts to improve the workings of its intergovernmental fiscal system. Clearly the direction must rest with the Russian government, and with the interagency commission it has appointed to lead the government's work in this area. The foreign advisors will play a technical role, and will bring international experience to the work.

The following activities could take place under such a program.

Comprehensive Review and Analysis of Options

The present system of intergovernmental relations will be comprehensively reviewed with the government by the technical assistant team, and the Russian experts on intergovernmental fiscal relations. During the review, the options for reforming the system will be systematically identified and evaluated. The output of this review and evaluation will be a policy paper on intergovernmental fiscal relations which will exhaustively explore the options, and which could serve as the basis for a reform. The analysis will systematically explore all of the tax assignment, revenue sharing, and expenditure assignment choices, along with their implications for the specific situation of the Russian Federation, and will identify implementation issues.

Fiscal Analysis Unit

The project should, as the first order of business, undertake the development of a Fiscal Analysis Unit (FAU) through the establishment of a Russian/American working group in training and collaborative research.¹ A special high-level training program should be developed for this unit. The output of this activity will be a functioning fiscal analysis unit capable of participating heavily in the comprehensive review, and capable of leading the fiscal planning work in the future. To support the work of the FAU, the technical assistance would develop and implement a revenue and expenditure forecasting model; and develop the capabilities to estimate impacts

¹Ideally, units would be established simultaneously in the executive and legislative branches of government. However, this is a determination that must be made somehow by the Russian government.

of federal policies on subnational government finances, and to do so in a manner that permits accurate comparative analysis of impacts across all subnational units.

Fiscal Information System and Modelling

To accomplish the foregoing, the project will have to develop the data systems necessary to support modern fiscal analysis. Specifically, this will require:

1. A census of governments that would bring together the fiscal data for federal, oblast and rayon-municipal government levels, and would allow regular analysis.
2. An enterprise level sample that would enable analysis of the impacts of alternative VAT and income tax structure changes, on an oblast level, on revenues of these jurisdictions.
3. A data set that would enable the State Tax Service (STS) to monitor the efficiency of its collections at the local level. Technical assistance here would be directed at streamlining the reporting system used by the STS.

The proposed technical assistance also would develop the models to be used with these data. The output of this activity would be a set of models (software, etc.) that could be regularly updated without external assistance. The models developed would be of three kinds:

- Straightforward revenue and expenditure estimation models that can be used in capital budgeting and long term fiscal planning.
- A microsimulation model of individual taxpayers (enterprises in this case) that can be manipulated to estimate fiscal impacts.
- A simulation model of subnational governments, drawn to help estimate the impact of changes in fiscal policy on equalization, etc.

Oblast-Local Relations

The proposed technical assistance would support an oblast level analytic upgrading with much the same tasks as described above: modelling, data systems and staff training, and

upgraded procedures for fiscal planning. This work would be carried out, simultaneously, in several (perhaps three) provinces. It would also involve experiments in the implementation of new "local" taxes, if the government desired.

Property Taxation

Technical assistance should be offered to evaluate the options for a strengthened property tax. The technical assistance could be carried out at two levels. In year one, the contractor would work with the federal government in surveying property tax practices in the nation, and in evaluating the options for change. In years two and three, an experimental implementation in a single (or a few) oblast or rayon could be considered.

Budgeting and Financial Management

Technical assistance in budgeting should concentrate on five areas: (a) training in all aspects of budget preparation, execution and review; (b) upgrading the procedures used in the practice of budgeting; (c) a survey of software and hardware needs, and assistance in the development of suitable short and long term plans in the budgeting-EDP area; (d) the possibility of supporting technical assistance for the Treasury function (subject to approval of GOR-IMF teams working in this area), and (e) a general upgrading of the capacity of the government to use the budget for planning purposes.

Training

Because the fiscal federalism reform in Russia will be so dramatic a shift, it will require the support of a substantial training program. The training program proposed here covers three principal areas: (a) General public finance, to better understand the theory and management of intergovernmental systems as practiced around the world; (b) Modeling and the application of modern techniques to improve fiscal planning; and (c) Budgeting practices and expenditure program evaluation. The training should be delivered in several ways:

- Formal classroom, and "experience" training in the US.
- Training of "trainers" for Russian based courses.
- Short courses offered in Russia by US experts.
- Study tours.
- Conferences and special seminars, both in Russia and abroad.

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VII.	The Budgeting Process	Henry M. Huckaby
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I. CONCLUSIONS AND RECOMMENDATIONS FOR TECHNICAL ASSISTANCE

INTRODUCTION

Intergovernmental fiscal relations, the division of financing and expenditure responsibilities among the different levels of government, is a key policy issue to be addressed in the restructuring of the Russian economy. The central question is: Will Russia be a decentralized federalism, like the United States, or will its governance and finances be more centrally controlled?

The pulls toward and away from decentralization both are strong. On the one hand, Russia is too large and too diverse a country to have a successful central fiscal management. Oblast and local level governments should be given more authority to respond to local needs and more resources to deliver adequate levels of services and to relieve enterprises of the responsibility for delivering social services. These pulls are irresistible enough that Russia will be a more decentralized federalism in future years than it is now. Yet, on the other hand, some argue, credibly, that Russia's economy is too unstable at the present time to turn the main instruments of fiscal policy over to subnational government. The federal government must mobilize resources to control the fiscal deficit, steer investment toward national priorities, and compensate for income disparities among the regions. There also are political pressures that pull both ways: some want nothing less than total independence, some want to bring government decisions closer to the local population and to locally elected officials, and some centralists want to retain the power they have long had.

Russia today is in a transition period -- somewhere between a centralized and a decentralized system -- and neither the President nor the Parliament has decided on the kind of permanent system that should emerge. The resulting drift in policy is having uncertain effects on the economy and negative effects on the efficiency with which the fiscal system is administered. The intergovernmental fiscal system has for a time been less characterized by rules than it has by negotiation -- a situation that is more likely to exacerbate income disparities than to compensate for them.

The objective of the proposed technical assistance is to assist the Russian government in doing the analysis that will underlie the design and implementation of a new intergovernmental fiscal system, and to suggest a program of supporting technical assistance. It is necessary to take a broad view of intergovernmental fiscal relations in Russia. In addition to the traditional concerns -- the assignment of taxes and expenditures, and intergovernmental transfers -- it is necessary to consider tax policy and tax administration. Tax policy is an important part of the intergovernmental system because revenues from the major taxes are shared and because all tax rates and bases are centrally set. Tax administration is important because taxes are collected, primarily at the lowest level of local government, by a decentralized federal agency.

In this summary and recommendations chapter, we (i) describe some salient features of the present system, (ii) discuss the problems and issues to be faced, and (iii) propose a program of supporting research, implementation and training. A concluding section recommends an action program to the Russian government and summarizes a technical assistance program to effect repairs that will bring the Russian reality to what we understand to be Russian objectives.

POLICY ANALYSIS: REVENUE SHARING AND EXPENDITURE ASSIGNMENT

The Russian government is in the process of making new rules about its fiscal system, experimenting with different revenue sharing and expenditure assignment schemes, and trying to evaluate outcomes. The Administration, the Parliament and the territories all have made proposals to restructure the system. It is a good time for Russia to seek technical assistance to identify and evaluate policy options, upgrade administrative procedures, and train personnel. Perhaps there is no better time to share international experience than when a new system is being formulated.

The Present System

The Russian intergovernmental fiscal system is dominated by derivation-based tax sharing, *i.e.*, subnational governments are allowed to retain a specified percentage of the tax collected within their boundaries. All of the major taxes are central levies, and subnational governments have little or no discretion to alter the tax rate or tax base. The principle sources of shared revenues are the individual income tax, the enterprise income tax, the value added tax and excises. In the first half of 1992, these four sources accounted for more than two-thirds of subnational government revenues. Transfers to autonomous regions, and subventions, amounted to less than 15 percent of subnational government revenue.

Since early 1993, VAT sharing has been negotiated, with retention rates varying from oblast to oblast depending on "expenditure needs." Oblasts have been divided into three groups. The present retention rates are:

Group A: 24 regions at 24 percent
Group B: 8 regions at 20 - 48 percent
Group C: 50 regions at 50 percent

The enterprise income tax is levied at a rate of 32 percent. The oblast and federal shares are 22 and 10 percent, respectively. The individual income tax is levied at a graduated rate with most taxpayers subject to a 12 percent rate, and revenues are fully retained within the oblast. Excise taxes are levied on automobiles, alcoholic beverages, tobacco products and some luxury goods, at rates ranging from 14 to 90 percent. The federal government retains the excise on automobiles and 50 percent of the excise on vodka. All other excise tax revenues are retained by the oblast governments. Oblast-level governments receive subventions from the federal level. If, at year end, the federal government determines that oblasts are in deficit, a subsidy or subvention to remove this deficit is provided. This is done on an *ad hoc* basis and is a negotiated amount.

The revenue system is administered by a federal agency, the State Tax Service (STS). The STS is comprised of federal, oblast and local offices, but with a substantial amount of operational independence at each level. Most assessment, collection and recordkeeping takes place at the local (municipal and rayon) levels.

In theory, the present system of expenditure assignment among levels of government squares with the best principles of public finance in market economies. Responsibilities for service delivery are assigned according to the size of the "benefit zone." The federal government is in charge of foreign economic activity, major infrastructure investment, "fundamental science," and other services that carry national benefits. The federal government is also responsible for a share of expenditures in the social sector including universities, research institutions, hospitals, and other services characterized by major externalities. Oblast governments are responsible for

services with regionwide benefits such as roads, specialized regional hospitals, clinics, etc. The service responsibility of cities and rayons are mostly concentrated in the social sectors (health, education and social security), local roads and streets, and public utilities.

In practice, however, the assignment of expenditure responsibilities doesn't live up to these norms. There are three, very significant departures. First, the transition period has brought difficult budgetary circumstances for the federal government, and has resulted in the offloading of some expenditure responsibility to the oblast and rayon governments. The assignment of social safety net expenditures and some capital expenditure responsibilities to local governments are examples. Second, local governments could not exercise any significant measure of fiscal autonomy in decision making until 1992, and still face significant constraints on their decisions about the size and composition of the local budget. Third, state enterprises continue to play a major role in the provision of social services, though fiscal responsibilities are slowly being transferred to the government sector. Sorting out these problems with expenditure assignment and developing a more stable division of responsibilities is a high priority need of the Russian government.

Problems and Issues

The Russian government has not yet decided on the intergovernmental system it will adopt in the long run. For now, a negotiated system is in place where the federal government makes *ad hoc* decisions about the size of subnational government budgets, VAT sharing rates and subventions. But the situation has been in flux. Early in the transition period in 1992, the revenue sharing system was primarily an *ad hoc* affair with the MOF deciding, for each oblast,

on the level of the budget, the VAT sharing rate, and the "needed" level of subventions. By mid 1992, the VAT sharing rates were made uniform across oblasts and the system became less *ad hoc*, but by early 1993, it had returned to essentially the same negotiated arrangement as had existed before.

There was an attempt to formalize the revenue sharing system in 1992 with the adoption by Parliament of the "Basic Principles of Taxation," whereby the VAT would be assigned to the federal level and income taxes to the subnational level. Though there is considerable merit to the assignment approach, the conceptual and practical problems with this particular proposal were severe enough that the government never implemented the Basic Principles law.

A similar degree of uncertainty has developed on the expenditure side, primarily because none of the laws governing the system of intergovernmental relations in the Russian Federation systematically define the assignment of service responsibilities among the different levels of government. Because expenditure assignments are not specified by law, there has been no impediment to the federal government to offloading responsibilities on to the local governments when budget conditions so demanded. Most notably in 1992, the financing and delivery responsibilities for several important expenditure programs were shifted to subnational governments. These programs included cash subsidies for vulnerable groups, various family allowances, and consumer price subsidies for milk, bread, meat and baby food.

Why is the intergovernmental fiscal system *ad hoc*? Part of the reason is that the federal government is trying to control a substantial budget deficit and a high rate of inflation, and it has responsibility for forming a consolidated budget for the entire country. The expenditure monitoring system is weak, and there is inadequate central control of revenue mobilization

efforts, so the federal government sees it as essential to maintain as much flexibility as possible.

But the *ad hoc* approach has exacerbated a number of problems:

Lack of Correspondence Between Revenues Assigned and Expenditure Needs. There does not appear to be a correspondence between the amount of revenues assigned to the subnational level of government and the amount they need to meet their expenditure responsibilities. The underlying problem here is that decisions about revenue assignment have preceded decisions about the assignment of expenditures, and seem to be independent of any assessment of expenditure needs. Subnational governments complain about the lack of adequate compensation for these added responsibilities and see these as unfunded mandates.

Equalization. There is no reason to expect that the tax sharing arrangement presently in effect is equalizing, *i.e.*, that it allows oblasts with lower fiscal capacity (relative to needs) to retain larger shares. Any redistribution of funds to the poorer oblasts must result from a combination of negotiation and the *ad hoc* decisions of the federal government, with subventions and VAT sharing rates as the principle instruments. A World Bank empirical analysis of the system in effect in 1992, including the distribution of subventions, did not reveal strong evidence of equalization. The government has not taken an official position about the degree of equalization it desires, nor does it have the information necessary to measure the equalization resulting from its present programs. A high priority policy issue is for the government to develop an equalization policy -- what services are to be equalized and what is the degree of equalization sought -- and a method of implementing it.

Tax Administration. There are complaints, at both the federal and the local levels, that the tax administration system is deficient. The issue most prominently discussed is collection efficiency (some officials allege that the collection rate is as low as 40 percent), but the present information base is not adequate to monitor the true collection rate. Other major issues have to do with delays in the timing of payments, poor record keeping and cumbersome methods for dividing revenues among the federal, oblast and local levels of government. The result is that governments at all levels are strapped for resources, tax rates are high, and there is a substantial incentive to find ways to avoid full compliance with the legal system.

The following are problem areas often discussed by government officials:

1. In 1992, the tax structure was changed twice, expenditure assignment was altered in a major way, and the tax sharing rules were changed. STS officials at the lowest levels are not certain about the new tax laws, and there is little by way of a formal training program for these officials.
2. Some longstanding flaws in the system of tax administration have been magnified by the recent economic liberalization program. These include some ambiguities about the tax treatment of wages and social service expenditures under the enterprise income tax, and inadequacies in the books of account of enterprises.
3. The present staff is inadequate in size and training to carry out the tax administration duties assigned.
4. Computerization of the tax administration system is very limited, and procedures for assessment, collection and audit are not efficient.
5. Enforcement problems are especially serious for the self-employed. Records of tax liability are incomplete, collection efforts are not aggressive, and penalties are insufficient.
6. The link between the STS and the local governments may, in some cases, compromise full compliance with the tax laws. There are many examples of subnational governments making adjustments to the existing tax laws and to the rules for revenue sharing, and some oblasts are reported to have withheld payment of large sums to the federal sector.

7. The banks have withdrawn from the task of channeling tax shares to the appropriate level of government. Enterprises now make the distribution of tax payments among the three levels of government, and not surprisingly, this has caused problems with the revenue sharing system.

Revenue Mobilization. Whether the present system stimulates or dampens the aggregate level of revenue mobilization is an open question. On the one hand, subnational governments retain only a fraction of what is collected, and as a result they may not promote collections aggressively or they may not be willing to turn over the agreed amounts to higher level governments. To make matters worse, subnational governments may also expect that any budget shortfall will be made up by a deficit grant and this tends to dampen enthusiasm for an aggressive enforcement program. On the other hand, the present system does have elements that encourage revenue mobilization by subnational governments. The retention rates are high for both individual and enterprise income taxes, and many territories retain half of all value added tax collections.

The World Bank Study treated this issue as an empirical one, and analyzed the relationship between the level of revenue mobilization by oblast level governments, the share of revenues they were allowed to keep, and the deficit grant they received. The results do not show that oblasts with higher tax retention rates acted on this incentive to make a significantly greater tax effort.

Information and Fiscal Planning. The federal government in Russia must understand the impacts of its fiscal decisions, it must have an early warning system to detect problems, and it must be able to design compensating adjustments when the system fails. It is a major problem

with the present system that the information system available and the analytic models used will not allow these goals to be achieved.

There is no central place where responsibility for fiscal planning rests. Revenue estimation is done by both the federal and oblast governments, and within each it is done both in the Finance Department and in the STS. Little, if any, analysis of fiscal impacts is done. At the federal level, the Parliament does its own fiscal research, but has limited resources in this area. There is no single data base on which Parliament, MOF and the STS rely. There is no forum that brings the various federal agencies together to conference on the results of their analysis, and on their differences. Whatever fiscal planning is done is very short term in nature.

Possible Technical Assistance

In the policy analysis area, USAID could offer technical assistance to assist the Russian government to achieve the following objectives:

- To do a comprehensive review and analysis of the present system of expenditure assignment and financing options, and to design a workable system for the future.
- To put in place a continuing capacity for fiscal planning by developing a fiscal analysis unit and a fiscal information system.
- To develop the capacity of the State Tax Service to evaluate the performance of the tax administration in individual oblasts.

Comprehensive Review. It is an appropriate time for the Russian government to undertake a comprehensive review of the intergovernmental financing system. This review would carefully evaluate all of the options for restructuring the Russian federal system. Ideally, a high level Commission would be appointed. Such commissions have proven successful in many

countries. The Commission would carry out its studies with an eye toward making its recommendations within one year, and would remain in existence for two further years to oversee the implementation and undertake any necessary further design. USAID could provide technical assistance to support the comprehensive review. The key issue to be addressed in such a review is whether the goal ought to be a full tax assignment system, or some hybrid which uses piggyback local options and subventions in addition to shared taxes. Moreover, there is the issue of how quickly should the change to any new system take place, and what transition program is necessary.

The place to begin such a comprehensive review is with the expenditure assignment issue. The expenditure and service delivery responsibilities of the various levels of government must be decided before financing and tax sharing issues can be resolved. A concrete and stable assignment of expenditure responsibilities is imperative if the present negotiated system is to be replaced with an objective system of intergovernmental fiscal relations. There is no single "best" system of expenditure assignment or service decentralization, either in theory or in practice. All systems involve tradeoffs, and Russia needs to find its own compromise to the assignment of expenditure responsibilities. However, the international experience not surprisingly shows that objective and clearly stated rules are more frequently associated with stable systems of intergovernmental relations. This review should draw heavily on the international experience.

Two technical assistance activities in the area of expenditure assignment are proposed. First, a systematic, data-intensive approach to the redesign of expenditure assignment should be undertaken. The expenditure responsibilities of subnational governments and their financing requirements would be itemized and quantified. This will require an analysis of expenditure

responsibilities, function by function; and an estimate of financial requirements implied by these assignments. Any transfer of responsibilities, assets, enterprise ownership, or any central mandate for wage increases and price ceilings would be explicitly modelled and the impact on fiscal balance estimated.

Second, the responsibilities of the federal government versus the oblasts should be firmly established. To do this, the government must identify what expenditure responsibilities have been misassigned, and among these, which should be retaken by the federal government. This review should be supported by a thorough, empirical analysis of the impact of alternative expenditure assignments on both the federal and the oblast governments. The result will be recommendations for a realignment of expenditure responsibilities.

If expenditure assignment is clear, it will be possible to move toward a more transparent revenue sharing system that reflects the longer term policy objectives of the government. The comprehensive revenue review would begin with an analysis of each component of the revenue system and its sharing arrangements. The following are some of the most important topics to be covered:

1. A quantitative analysis of each of the shared taxes in the present system in terms of their distribution across oblasts. The objective would be to establish the extent to which each is equalizing, dampens revenue effort, and is revenue elastic.
2. A similar analysis of the distribution of subventions.
3. An evaluation of locally levied taxes.
4. An analysis of revenue sharing from natural resources.
5. A study of the special fiscal issues facing the largest cities.
6. An assessment of the administrative difficulties associated with the present system.

In every case, the analysis would be quantitative and based on primary data. The most modern techniques of fiscal analysis would be used, and the experience in other countries would be drawn on extensively.

The comprehensive review would consider the costs and benefits implied if a different system (than the present) were chosen. There are a number of reform options to be covered in a comprehensive review:

- Identify the various programs of tax assignment and tax sharing that might be considered and systematically evaluate the merits of each.
- Consider methods of assigning some degree of taxing independence to subnational governments.
- Develop a grant (subvention) system, less *ad hoc* and consistent with government objectives for equalization and local revenue mobilization.
- Evaluate the options for capital finance, including the possibility of giving some degree of borrowing powers to subnational governments.
- Strengthen local property taxation.
- Allow different degrees of fiscal discretion for larger versus smaller cities.
- Increase the reliance on benefit and user charges.
- Identify implementation problems and measure administrative costs.

The result of this work could be a White Paper on Intergovernmental Fiscal Relations that could propose options or even a full program for debate in Parliament and by the government. It could be the basis on which a new system could be developed for the post-transition period.

Fiscal Planning. The second activity under this technical assistance is to assist in the development of a continuing capability for fiscal analysis and planning. The technical assistance could lead to three tangible results:

- The establishment of a fiscal analysis unit (FAU) within the government.
- The development of a fiscal information system.
- The construction and implementation of a series of models that would allow the government to develop estimates of the impact of various fiscal policies on individual subnational governments, and on the subnational government sector as a whole. This would include the development of a sample of enterprise taxpayers that would allow the FAU to estimate the impact of any proposed federal tax reform (or enterprise reform) on individual oblasts.
- The construction and implementation of models to use for purposes of revenue estimation and expenditure forecasting.

STS Assistance. To the extent that the fiscal system which emerges in Russia involves some combination of shared taxes, shared tax bases or subventions -- and it is almost certain that it will -- it is crucial that the STS be able to make estimates of revenue collections for individual subnational governments. The STS must be able to monitor the efficiency of collections at the local level, and some fiscal authority must be able to estimate the impacts of changes in federal tax policy or administrative procedures. Moreover, the STS data on tax collections and tax bases are essential if a fiscal planning system is to be implemented.

Technical assistance to support this objective should include, first, an upgrading of the tax reporting system for each subnational STS office. Computerization and more rapid transfer of data to the oblast and federal offices, and some effort at making the data more comparable, could greatly enhance the capacity of the STS to support the fiscal planning exercise. Second,

it is necessary to provide training and model development to take advantage of this improved information system.

The objective of using the models is for the STS to estimate revenues, develop an early warning signal for shortcomings in local administration, to monitor tax sharing distributions, and to assist in the management of the workload of tax inspectors. The models developed should be revenue tracking systems whereby monthly revenue performance could be evaluated, even at the sub-oblast level. The STS would have to set up a central analytic cell to support this work. A training program and appropriate software development and hardware purchase would be necessary to support this activity.

Finally, the STS is in need of a considerable amount of technical assistance to upgrade their basic tax administration system. All facets of the system -- taxpayer registration, assessment, collection and audit -- are in need of assistance. This will require coordination, however, with the IMF, which is actively involved in a pilot project in value added tax administration.

ENTERPRISES AND EXPENDITURE ASSIGNMENT

Many large state enterprises perform a dual role in the Russian economy: they produce goods and services for sale to customers, and they provide a range of social services to their employees and to others in their communities. These social services include child care (kindergartens), sports and cultural facilities, clinics, cafeterias, and, importantly, housing. In some respects, then, state enterprises are an extension of government.

Under the new Russian economic structure, most of these enterprises are to be privately owned, and the responsibility for these social services are to be transferred to subnational governments. Thus, the government sector, and particularly subnational governments, are being asked to absorb a potentially significant increase in service delivery and financial responsibility.

Conclusions and Issues

This reassignment of expenditure responsibility raises three important issues. First, there is a concern that the privatization process will be slowed down because local governments will be reluctant, or unable, to assume the financial and administrative responsibilities implied. Second, there is a concern that local governments will be unable to finance social services at even minimum levels. Third, there is the broader issue of the proper role of enterprises and of local governments in the provision of social services, *i.e.*, whether there are some social services that enterprises should provide.

To begin to answer some of these questions, and to further identify the issues, a survey of enterprises was carried out as part of this project. Based on this survey, the following conclusions were reached:

- Enterprise expenditures on social services vary widely in amount, even when the size of the enterprise and its financial characteristics are taken into account. Expenditures by larger firms are substantial and involve an extensive list of services.
- Social services may be provided to all workers of the enterprise, to selected workers at the enterprise, or to all residents of the community. Thus, many of these services cannot be considered simply as fringe benefits or as in-kind compensation for the workers of the enterprise.
- Expenditures for housing constitute the bulk of social service outlays by most enterprises.

- Much of the social service expenditure made by enterprises is treated as deductible in computing company income tax liability. However, there is an *ad hoc* treatment as regards deductibility, and the percent of the expenditures that is actually deducted varies by enterprise and by municipality.
- The basic conclusion from this illustrative survey is that the transfer of responsibility for social services from the enterprises to the municipal governments will impose a significant financial burden on the receiving governments.
- The transfer of the responsibility for social services has been largely postponed because most enterprises have agreed to continue to finance these services, at least for the present.
- The necessity of continuing the provision of social services has had little impact on the privatization of smaller enterprises because these enterprises do not provide substantial amounts of social services. It is thought (by some Russian officials) to have some impact on the privatization of the larger enterprises, but this impact is not easily quantified.

Recommendations for Technical Assistance

Technical assistance could be helpful in planning and implementing the transfer of social services from the enterprises to the subnational governments. The first need of the government is to gain a better understanding of the dimensions of the problem. The information presented in this paper, and summarized above, is based on a small, non-random set of enterprises. The sample must be considerably larger and must be representative, *i.e.*, it must include smaller enterprises, enterprises that have not yet begun the privatization process, less financially successful enterprises, and enterprises from across Russia. The information gathered in the survey should include:

- the income statement of the enterprise, including the annual costs of providing social services, the revenue obtained from their provision, and the tax treatment of these expenditures;

- the assets and liabilities of the enterprise, including the value of any assets used to deliver or maintain social services;
- the number of employees in the enterprise; and
- the details of the enterprise's privatization (if relevant).

The technical assistance should involve first, a complete design of a questionnaire to be administered to participating enterprises. Second, this should be field-tested by a technical assistance team, making sure that appropriate representation of enterprises is included in the field test. Third, a mock-up of the analytic results from the field test should be reported, as a method of designing the analytic model that will be used to report the results. Fourth, a team of surveyors should be trained and given field experience. Fifth, the random sample should be drawn and the survey conducted. Finally, the results should be tabulated and analyzed. The work would be done jointly by USAID advisors and the Russian Fiscal Analysis Unit.

The survey is designed to answer a number of questions that are central to forming policy and designing an implementation plan to bring social services into the government sector. The following are the most important considerations:

Impact on Subnational Government Finances. Research is necessary to answer a number of questions:

- Are social service costs absorbed at marginal or average cost?
- What is the "net" cost of absorption for each ruble of social service expenditure transferred, *i.e.*, after taking account of the changes in company income tax revenues that would accrue to the local government?
- What transition period is necessary?

- What continuing (administrative, operating and maintenance) costs will be absorbed by the subnational government?
- What is the total magnitude of incremental costs that will be imposed on the receiving governments? How widely does this incremental cost vary across oblasts, and within oblasts?

General Social Services Versus Fringe Benefits. Present law requires that most social service expenditures be transferred from enterprises to the local government. While the analysis based on this survey concludes that most of the social service expenditures made by enterprises are not fringe benefits, more detailed analysis is needed to verify this. It is necessary to survey enterprise-provided social services in much greater depth and to use the results of this survey to establish some concrete rules about what constitutes a fringe benefit and what constitutes a social service expenditure. One way to do this is to work within the proposed enterprise sample to identify beneficiaries of each perquisite provided, and to try and determine the extent to which social service benefits capitalize into wages.

Privatization of Enterprise Housing. The major component of enterprise expenditures on social services appears to be for housing. This conclusion needs to be verified, and it needs to be supported with information about whether the expenditure is for construction, maintenance, supporting facilities, etc. Then the issue of transfer must be addressed. But because of its complexity, this issue requires thorough study in a context of the present housing reform proposals.

Revenue Instruments for Subnational Governments. Assuming that the conclusion holds that the cost to subnational governments is substantial, then it is important to evaluate the options for covering this additional cost. The two most often discussed options are user charges and increased local taxes. A feasibility study is necessary to determine the appropriate and needed level of user or benefit charge for each social service, and the general local government revenue sources that might be used to fill this financing gap. This could be done as a combination of case study and simulation analysis using the enterprise and municipal samples.

In the absence of an agreement between the enterprise and the municipality that delays the transfer of social services, local governments face the prospect of soon becoming responsible for a large and unpredicted increase in expenditures. Until a viable financing plan can be put in place, consideration might be given to a program of short-term budget relief. This might take the form of a grant from the oblast or central government. One important contribution of technical assistance would be to evaluate the alternative transition mechanisms.

Other Issues. The experience of the Russian government has been that the implementation of the transfer of responsibility for social service expenditures raised more questions than had been anticipated, and indicated that further planning for implementation could be beneficial. Among the issues encountered in the survey are (i) the compatibility of the public utility system supplied by the enterprises and that supplied by the local governments, (ii) problems encountered because of the inefficient size and improper location of the physical facilities used by the enterprises, and (iii) problems concerning the transfer of equipment owned by enterprises but used partly or wholly to maintain social services. Issues such as these must be considered as part

of any implementation plan. Technical assistance can help this aspect of planning for implementation.

THE BUDGET PROCESS

Budgeting in Russia is a "top down" process, and there is strong central guidance. The Ministry of Finance develops two budgets: the federal budget and the consolidated budget (which includes all sub-national governments). Each governmental unit does have its own budget, but these are subordinated to that of the next higher authority. A 1991-1992 law specifies the documents, terms and time frames of the budget cycle, and there is a similar law at the oblast level governing subordinate local units. However, because of the unstable economy and political situation, the budget laws have not been implemented.

Preparation and Execution

Budget preparation is initiated and controlled at the federal level, and not surprisingly, is driven by estimated revenue collections. The Ministry of Finance, using data from the Ministry of Economy (MOE), produces estimates for all revenues and expenditures for the federal government and for each oblast level government. Formally, the proposed expenditures are based on federally established expenditure norms. Informally, however, officials repeatedly advised that these norms were not used. In practice, expenditure estimates are routinely a function of the previous year's expenditures, and revenue constraints.

The MOF then entertains a response to the initial budget proposal from each oblast. At this point a negotiation process begins, and each oblast goes to Moscow to present its case.

Agreements and disagreements are recorded in what is termed a "protocol." Subsequent to the oblast visit to Moscow, the same negotiation process takes place at the oblast level, where revenue and expenditure estimates are debated with each rayon. Eventually, final budgets are approved by the respective heads of administration and the local soviet.

The responsibility for budget execution at the federal and subnational levels rests with their respective finance offices. Numerous reports are prepared on a monthly, quarterly, and annual basis at all government levels, and are submitted to the appropriate superior level. When a local government budget is approved, there is considerable flexibility in moving funds between line items, and even between departments. Each level of government is charged with a budget inspection responsibility, to ensure that the minimum expenditure norms are being met in the respective functional budgets, and to ensure that an overall budget shortfall is not taking place. Such inspections are conducted in two ways: document examination (desk reviews) and field inspections.

Problems and Issues

The budget issues and problems in Russia are a reflection of the procedures and policies of a highly centralized system that discourages participation by lower level governments. The more immediate and specific budget issues of concern can be defined as follows:

- The budget process in Russia remains top down; therefore, federal budget officials do not make best use of the ideas and experience of budget officials at the lower levels of the intergovernmental system. The time horizon is no more than one year, and the principal concern of budget officials seems to be prevention of budget deficits.
- Numerous budget reports are prepared monthly, quarterly and annually, but they are not "budget" documents in any modern or contemporary sense. Their utility

is primarily to track cash-flows to assure that expenditures are not made prior to the receipt of adequate revenues. These reports are not instructive as to what objectives are actually being met with government programs.

- The value of the budget reporting system is further hampered by the generally low level of computerization, the absence of integration of those computer systems which do exist, the lack of adequate software and hardware, and the lack of understanding and appreciation of computer technology by the lower civil service ranks.
- A related problem is that of employee utilization, morale and training. It appears that too many staff resources are devoted to relatively low level budget work thereby allowing little time and resources for analysis, evaluation, and planning. Training is not offered on a routine basis, which partially accounts for some of the staff resistance to computerization efforts. In general, government employees appear to have poor or out-dated equipment, poor salaries, and generally poor working conditions.
- There exists no sustained and coherent capital budgeting policy.
- A true audit function does not exist. The current budget inspection process appears to be relatively informal and intermittent.

Reform Objectives

The reform of the budget process in Russia should concentrate on five objectives:

1. Budgeting should incorporate a long range perspective.
 - Specific strategic plans should be developed for each expenditure program, and for the budget as a whole.
 - Capital budgets should be linked to operating budgets.
 - Revenues and expenditures should be identified for specific government enterprises and, in some cases, services.
 - The fiscal and economic impact of mandated services or regulatory practices should be identified and measured.
2. Government executives and managers at all levels should have implementation flexibility and be appropriately recognized and rewarded for efficient and innovative use of resources.

3. Performance measures and benchmarks for accountability should be established.
4. Reliable forecasts of revenues, expenditures, and general economic conditions should be a part of the budget system.
5. A coordinated two-way system of communications for both policy setting purposes and budget management and control purposes should be instituted. Participatory budgeting rather than imposed budgeting is the proper approach.
6. Capital budgeting should be an integral part of the general budgeting process.

Recommendations for Technical Assistance

Technical assistance is needed in all aspects of public budgeting and fiscal management. Some activities can begin immediately, and can yield near term results. These technical assistance projects should be jointly designed and initiated by Russian government officials and USAID public finance experts.

Budget Policy. As the Russian government moves to a market economy definition of the roles of government and enterprises, the introduction of contemporary concepts of budgeting becomes essential. The following technical assistance efforts in the budget policy area could begin immediately:

1. Building a pool of highly qualified civil servants to manage a radically different government structure in the Russian Federation of the future is a high priority. Technical assistance in developing budget procedures and training could be provided in various sites in Russia by US training teams.
2. Prior to sending such training teams to Russia, it is recommended that significant training take place in the United States. This can best be done jointly by US university and government agencies, drawing on appropriate technologies and methodologies. Teams of Russian budget practitioners would do the following while in the United States:

- Acquire intensive graduate level instruction in budgeting theory and concepts, capital budgeting principles and practices, public finance theory in a market economy, basic revenue estimating methodologies, and an introduction to public accounting;
- augment the classroom instruction with budget practicums in federal, state and local government environments; and
- be assigned specific responsibilities in the preparation of instructional materials to be used in Russia by returning Russian nationals and American technical assistance teams. The tasks involved in preparing such materials would include, but not be limited to, planning and design of instructional manuals, forms, and procedures; production of such materials in the Russian language in both written and video media; and the design and production of instruction syllabi to be used in Russian universities or other training venues.

Budget Information Systems. Russian government officials recognize the need for uniform reporting systems and the need to computerize the reporting of information. However, until overall national budget and program objectives are laid down at the federal level, the current reporting system is likely to remain in effect. Even in the interim, however, some important short-term actions should be taken.

Prior to the actual design and application of any computer hardware and software systems, an accurate and detailed operational description of the Russian budgeting and financial management system must be developed. To initiate this activity, three US-based technical teams (one for each level of government: national, oblast, rayon) should begin work with Russian teams to inventory the quantity and quality of computerization currently used, define and chart the basic information flows and needs of the current reporting system, determine the availability of current software systems which offer promise of expedient modification and installation,

inventory and assess the availability and quality of Russian resources to develop software, and prepare a coordinated report.

Technical assistance should be offered to the new Federal Treasury to assure that its operations are appropriately computerized at the outset. It is possible, if done properly and at the outset, that the Treasury can replace and simplify many of the reporting functions of the budgeting process and simultaneously serve as an applied laboratory for the computerization of the entire budgeting and financial management system. The IMF has designed a program of supporting technical assistance for the new Treasury, but it is not clear how far this program has developed, or if it is to include the subnational governments. Any technical assistance offered by USAID in this area should be carefully coordinated with that being offered by the IMF.

The successful transition from basically a manual system of budgeting, financial management, and public sector accounting requires substantial training of lower level staff. In the near term it is recommended that technical assistance resources be used to train the "trainers" in computer skills. This training should have two components. The first is training of a cadre of Russians in the United States, using the approach described above. The second is that the government should establish, perhaps with USAID support, several permanent computer training laboratories, to be staffed and managed by professionals from the cadre trained in the United States.

Strategic Planning, Program Evaluation, and Cost Accounting. The Russian Federation should establish a system for ordering the priorities of government expenditures and for evaluating the effectiveness of ongoing expenditure programs. This requires technical assistance

in the form of training (in-country and abroad) and the development of standard procedures. There are three areas of concern. The first is strategic planning, which is pivotal to adopting a longer time horizon in public budgeting. The second is program evaluation, an empirically based research approach to studying the design of government programs, to describing and documenting the implementation strategies and assumptions of these programs, and, ultimately, qualitatively and quantitatively assessing the effectiveness of these programs. The third is a cost-managerial accounting and control system, a method of accounting that permits quantitative analysis. It is recommended that a training program be established to introduce Russian budgeting and financial professionals to the cost-managerial accounting concepts, cost behavior and cost estimation methods (such as cost allocation methods and cost determination systems). At a later point, these approaches to budgeting might be introduced in Russia on an experimental basis.

FISCAL FORECASTING AND INFORMATION SYSTEMS

A modern data base and information system are necessary to improve revenue and expenditure forecasting efforts, and to support the general program of fiscal planning and management. Because the Russian economy and economic policy are in transition and are likely to be for some time, there is a premium on being able to accurately monitor fiscal performance.

Problems and Issues

The main forecasting, data and financial management problems faced by the federal and subnational governments are as follows:

1. At all levels of government, the methodology used to forecast revenue is highly aggregated. There is no use of micro-level data.

2. Little is done by way of estimation of the impacts of changes in the tax law, either on aggregate revenues or on the revenues of individual oblasts.
3. In practice, expenditure forecasts are not made.
4. There is no long term fiscal planning, *i.e.*, analysis of different adjustments of revenue or expenditures to achieve budgetary balance.
5. Capital expenditures are not a component of the regular forecast of the government budget.
6. There is significant potential to establish a fiscal information system, but data transfer and coordination among agencies is problematic. The data transfers are mainly hard-copy and there is little reliance on computers. Timing is a particular problem because some data are transferred through four or five agencies. Data are not currently coordinated by the various federal offices, but most data do reach some federal office.
7. There is insufficient computer hardware and software available to either develop a fiscal information system or to carry out a modern approach to forecasting.
8. There is a shortage of trained personnel to carry out the forecasting function at necessary levels. There also is a lack of trained personnel in the areas of budgeting and data collection.
9. A lack of audit training has led to significant underreporting and underpayment of taxes by enterprises.

Technical Assistance

There is significant potential for the development of an integrated data system to support a modern fiscal management information system. In fact, all of the appropriate data (planned and executed budgets at all levels of government, tax revenues, socio-economic and demographic, and information on profits and expenditures of enterprises) are now collected at some level of government. There are two basic problems to overcome in establishing a useful fiscal information system for the Russian Federation. First, the current flow of necessary fiscal data is slow and it is transferred in a cumbersome way. Second, there is no daily monitoring of

expenditures and revenue by the MOF. These two basic issues can be resolved with technical assistance from USAID. In addition, USAID may offer other forms of important technical assistance to upgrade the fiscal information system.

A plan of technical assistance in these areas might be as follows:

1. Survey the rayon and oblast STS offices across the country for information regarding software and computerization. The survey should be conducted to determine the existence of software to register enterprises, keep financial records of enterprises, calculate tax liability, keep accounts of payments made, and audit companies. The survey should also determine the types of computers used and modem potential.
2. Upon completion of the survey, it is necessary to identify the software and communications needs of the STS. Beginning with pilot programs in one or two oblasts, USAID could develop communications software, provide necessary hardware (PCs and modems), and provide training to develop a database and transfer data from the rayon to the oblast and central STS office. Specifically, the needs in this area are:
 - Computerization of the tax payment recording process.
 - Development of uniform standards of reporting from the rayon to the oblast to the central STS office.
 - Design, development and installation of software to collect, process and tabulate data according the specifications above.
 - In the central STS office, further software development is necessary to produce an annual compilation of tax collections by type of tax, industrial sector and level of government.
3. An additional assistance project within the STS is the establishment of a sample of tax returns. USAID can provide the assistance necessary to capture the enterprise tax returns into a database for use by the STS and the fiscal analysis unit of the MOF.
4. As a stand-alone project, USAID can begin technical assistance in the areas of revenue and expenditure forecasting and estimation.
5. There should be a survey of the models and computerization used by finance offices at the oblast and rayon levels in order to determine the level of sophistication across the country.

6. Once the federal Fiscal Analysis Unit has been defined, USAID can devote resources to the development of modelling and computerization of the unit. The technical assistance would:

- Develop a revenue forecasting model for the MOF. This would include software development for forecasting the VAT, enterprise income tax, excise taxes, customs duties, and the individual income tax at the central level (total revenue in the country).
- Provide software that incorporates the ability to allocate revenue to the various levels of government.
- Develop revenue estimating capabilities. This would include estimating the impact of changes in the tax code and sharing rates. The software should enable the analysts to determine the impact of changes in each region of the country.
- Expenditure forecasting software and methods should be developed in the Fiscal Analysis Unit. The software should have the capability to incorporate effects of changes in the expenditure responsibility at all levels of government.
- All software development should be done with input from the analytic unit responsible for providing the estimates. Once the software is developed, two short-term advisors might be sent to Russia, one for hardware support and one for software use support.

7. USAID could provide assistance in the development of a fiscal information system, combining data from the MOF, STS, and SCOS. This would involve coordination among these offices, computerization of data and collection methods, and integration of a large quantity of data. This project could be broken down into three categories, each of which could be addressed separately by USAID.

- Taxpayer return data (STS): The technical assistance required for these data has been described in (3) above.
- Central and local budget data (MOF): In conjunction with the Budget Execution Office of the MOF, the first priority is to establish the format of a detail report of budget execution information for the local and central governments. Software should be developed to produce the report in a uniform fashion (in coordination with the work on budgetary procedures, this software could also be developed to produce the report from uniform budget execution data held by the local governments). Finally, PCs and modem communication should be established in the pilot rayons and oblasts for data transfer from the rayon to the oblast to the central government.

- **Socio-economic and demographic data (SCOS):** Assistance could be offered to the SCOS to develop the capability to collect and distribute the data in a timely manner. This may involve software development, computerization of data, and data transfer.

8. **USAID could provide assistance to the development of the new Treasury department within the MOF in conjunction with the plans of the IMF. The assistance that USAID could offer the Treasury is as follows:**

- **Establish the necessary computerization of the Treasury and software to enable daily monitoring of the budget.**
- **A USAID long-term advisor could be assigned to the Treasury, if this fit the government's and IMF's long-term plan of support. In turn, the advisor could offer training for new Treasury officials, in coordination with government and IMF intentions.**

9. **If daily monitoring of the central budget cannot be arranged through the Treasury, USAID can help to establish and train a new department within the Budget Execution Department of the MOF to monitor daily collections and expenditures. The assistance necessary would be identical to that in (8) above. At the local level, USAID could offer the following assistance for daily budget monitoring:**

- **Software development and training to establish a link with the local STS office.**
- **Computerization of expenditure execution. This activity includes software development to link the bank and finance office to immediately account for disbursements.**

10. **Training in the areas of public accounting, budgeting, fiscal analysis, and statistics is needed at all levels of government, but especially in the new Fiscal Analysis Unit and in subnational government finance departments.**

OBLAST²-LOCAL FISCAL RELATIONS

The oblast Soviet is responsible for the allocation of financial resources among the rayons and municipalities within the oblast. It determines the share of taxes that may be retained by

² We use the term "oblast" here to refer to all oblast-level governments.

each constituent local government unit, and it may choose to allocate an additional subsidy to selected local governments. It therefore determines the level of spending by each local government in the oblast.

It seems that no two oblasts approach the revenue sharing issue the same way, hence it is difficult to define a "national practice." Some oblasts extend the federal approach and share taxes among subordinate units with a derivation approach. Others devise equalizing programs whereby they transfer resources from the richer to the poorer local governments. Moreover, each time the federal government changes its revenue sharing percentages, a chain reaction is set in motion whereby each oblast makes a series of changes in the structure of fiscal relations with its lower level governments.

Any new system of federalism adopted must face the oblast-local issue. Even under a decentralized assignment system -- if that is what the government finally chooses to adopt -- it is crucial that the system be designed to promote efficiency in the operations of subnational governments, and that equalization objectives be achieved. Given the great disparities in wealth among the regions in Russia, and within the regions, this will be no easy task.

Problems and Issues

The following are the most often discussed problems and issues:

1. **Fiscal Disparities.** There are wide variations in economic well-being and in fiscal capacity within each oblast, but the enactment of equalization features in the revenue sharing system by the oblast Soviet has raised some tensions with better-off local governments -- particularly the urban centers -- who feel that they are unduly discriminated against to underwrite equalization. The information system available at the oblast level does not enable officials to do a thorough analysis of the extent to which any particular revenue sharing or subvention proposal is successful in equalizing fiscal capacity.

2. **Revenue Raising Efforts.** Equalization may tend to dampen efforts to increase the rate of revenue mobilization. The less tax an oblast allows its rayons/municipalities to retain, the less a rayon will be willing to push its constituency to a higher tax effort. And if the oblast provides a deficit-covering subvention to the rayon, then the incentive to mobilize more revenue at the lowest level will be dampened even further. There appear to be many ways in which the lowest level local governments may discourage revenue effort: by failing to impose local taxes and user charges when there is an option, providing preferential treatment for particular enterprises, not encouraging STS officers to be aggressive in collection efforts, and outright refusal to turn over shares of collections to the higher level government. Under a fully decentralized federal system, the problem would be magnified.

3. **Planning Certainty.** Oblast and lower level local governments need to know the revenue flow coming to them with enough certainty to plan their budgets. But the present revenue-sharing system is changed so frequently that efficient fiscal planning is virtually impossible. The problem is further exacerbated by the delays in approving the budgets of higher level governments.

4. **Local Autonomy.** Local government is less efficient than it might be, because local voters and officials have so little say in the formation of the budget. As things stand now, higher level governments mandate services and decide on tax rates and bases, and rayon level governments are given very little discretion. This issue has left the federal government with a quandary. Do they give the rayons some discretion in setting tax rates, and if so, what taxes do they assign to the lowest level governments? Or does the government stay with a traditional federalism and leave it to the oblast level to decide on the powers to be given to the lowest level local governments.

5. **Derivation-Based Income Tax.** The individual income tax is allocated fully to the rayon where collection takes place -- where the job is located. Because none of the revenue goes to the place of residence, a mismatch is created between the rayon where a worker uses many of the services provided by local government (e.g., education and health) and the rayon that receives the tax paid by him. Clearly there is an unfairness in this, and it is left to the oblast level government to develop a compensating mechanism. But how is this to be done, and what kind of subvention is necessary to offset the disparity? Because they lack adequate data, oblast officials cannot easily design a fiscal instrument that compensates the "residence" local government for its overburden.

6. **Federal Policy.** Oblast fiscal discretion in their relations with lower level local governments may compromise the success of federal fiscal policy. For example, the federal government may choose a counterequalizing distribution policy in order to stimulate revenue mobilization, but the oblasts may choose to equalize and therefore offset this goal. There are many other possibilities, e.g., oblast governments may not allocate adequate resources to lower level governments to operate and maintain federally constructed capital projects. The point is that fiscal decentralization, by its nature, compromises the ability of the central government to control total public sector activity.

Reform Options

The government is at a crossroads in deciding how to deal with intra-oblast relations. In general there would seem to be three strategies. The first is complete centralization, *i.e.*, make intra-oblast relations a direct responsibility of the central government. There seems to be little sentiment for this approach. Second, allow the oblast Soviet to decide on the basic fiscal structure, but prescribe a set of central mandates to constrain the decision so that it more or less matches central objectives. Third, leave the situation as is, and let each oblast work out its own difficulties.

The second and third options are the most often discussed. Many countries have prescribed specific powers for their lowest level governments, particularly when they thought that the state (oblast) level would not make distribution decisions that were in the national interest. Proposals to mandate certain revenues for lower level local governments have been made in Parliament.

Continuing with the present framework -- leaving the distribution decisions to each oblast Soviet -- would seem a reasonable option. It would involve less shock to the system at a time when the system is fragile and undergoing major changes. It would continue to leave accountability for fiscal decisions with the oblast Soviet, and it would be consistent with the reality that certain oblasts/republics will be given greater autonomy.

Possible Technical Assistance

In Russia, any policy initiative to change the relationship between oblast and lower level local governments will have to come from the federal government. The first step in a technical

assistance program then, is to carry out a survey of the practice throughout the country so that the dimensions of the "problem" are well understood. This sort of survey is carried out in nearly all federal countries on a regular basis.

There are five general areas where technical assistance to the oblast level governments can be useful.

1. **Fiscal Analysis Unit.** USAID could provide technical assistance to develop a Fiscal Analysis Unit (FAU) for selected oblasts. The functions of the unit would be to carry out the analysis that would inform the decisions about revenue sharing and expenditure assignment within the oblast. The technical assistance could train the officers in the FAU, and work with them in a comprehensive review of the present system of intra-oblast revenue sharing. The functions of the FAU would be the same as described above for the federal FAU. The first activities of the FAU would be a review of the present system and an evaluation of reform options, and the development and implementation of a forecasting model for revenues and expenditures.
2. **Information System and Models.** The FAU would need the support of a fiscal data system and a set of analytic models. Technical assistance would be needed to design the information system, construct the models, and implement the system. The models would be in the nature of microsimulation models with the capacity to analyze the impacts of alternative policies towards lower level local governments. The information system would include detailed data on expenditures, revenues, tax bases and socioeconomic characteristics of all constituent local units. The information system would be a computerized data base, with comparable information from every local government in the oblast.
3. **Budgeting and Financial Management.** Selected oblasts could be singled out for improvements in their budgeting and financial management systems. The technical assistance would follow the program outlined above for the federal government, and would involve training, the development of procedures, and computerization. The intended result would be an upgraded system of budget preparation, execution and review, supported by a modern computerized information system and operated by skilled staff. The goal would be for this program to be a model for other oblasts. The models would be in the nature of microsimulation models with the capacity to analyze the impacts of alternative policies towards lower level local governments. For example, it should have the capacity to estimate the change in the distribution of revenues and expenditures across rayons if the revenue sharing formula were changed, or expenditure mandates were introduced, or the federal government changed the income tax rates, etc.
4. **Pilot Projects on Local Taxation.** Various local governments in Russia have been experimenting with local taxation practices, and government policy has been moving slowly in the direction of giving local governments more fiscal discretion. Technical assistance might be

used to help identify areas where benefit or user charges might be levied or increased, and to implement the program. Local surtaxes are growing in importance in Russia. In fact, many of the "permitted" 49 local taxes are surcharges. Technical assistance could assist a pilot oblast to develop one or more of these surcharges in terms of both structure and administration.

5. Pilot Project on Local Property Taxation. The Russian government has shown much interest in moving toward a local property tax, and it is a good time to begin planning for this. Technical assistance could be useful, particularly in the following areas:

- Evaluate the available information from BTI to determine whether there is some possibility to move to even a rudimentary value-based tax. The impressive data set already compiled by the BTI may provide the basis for land-value mapping and some form of simplified cost-based valuation of structures. Technical assistance, including data analysis, programming, and provision of computer capacity, will be essential in helping to utilize this information most effectively, and making a judgement about its usefulness.
- An early technical assistance activity should be directed toward evaluation and coordination of the pilot projects now underway concerning the development of a comprehensive cadastre, either through an integrated register of physical, legal and fiscal data or through separate systems that can be coordinated with one another. This raises a set of very complex issues. There are numerous international assistance projects in this area, and these may be somewhat incompatible and affected by the need to promote individual commercial systems. The goal of this evaluation would be to come to some conclusion about the kind of cadastre that Russia should develop.
- Technical training in all aspects of property tax administration will be required. Among these are data collection and management, individual and mass appraisal techniques, billing and collection procedures, provision of taxpayer information and handling of appeals, and administrative issues such as planning, budgeting and personnel management.
- Another element vital to an operational property tax is clarification of the legal background to property ownership and tax liability. The current ambiguities, contradictions, and inconsistencies found in the laws on property ownership, privatization and taxation not only impede investment and market development but also prevent clear assignment of responsibility for payment of the tax. These elements of taxation require clarification of current property rights and greater consistency among the legal enactments concerning rights of ownership. Although this is an ambitious task that has implications far beyond the area of property taxation itself, substantive reform of property taxation requires a rationalization of property law. This is an important area for technical assistance.

Once the property tax structure has been identified, then it is necessary to deal with implementation problems and strategies. The property tax always poses serious implementation problems, and an experiment in setting up its administration could be a good way to phase in a more intensive use of the tax on a nationwide basis. Among the implementation issues to be dealt with are (a) the proper identification of the parcels and the liable taxpayers, (b) the setting up of a recordkeeping system, (c) assessing the base of taxation for each unit, and (d) setting up a collections and appeals system.

A resident advisor in property taxation could be assigned to a single oblast, and perhaps a single rayon, for a two year period to develop and test this implementation plan. He also would serve as the training officer for the program. Likely, implementation would initially be restricted to a single rayon.

TECHNICAL ASSISTANCE PROGRAM

The full details of a technical assistance program cannot be worked out until the Russian government identifies its priorities and the directions in which it is willing to move. In particular, the decision about whether to move to a full tax assignment system or a system of surtaxes and subventions will play an important role in determining the type of technical assistance required of the project. It is quite a different matter to assist in the implementation of a locally administered company income tax -- complete with proration formulae for inter-oblast allocations -- than it is to develop a procedure for subnational governments to levy surrates on national taxes. And even when the major policy decisions are made, there is more work to be done in fleshing out the detail of the technical assistance to be provided. A good example

is in the fiscal information area. The actual difficulty of undertaking the data gathering exercises proposed here cannot be determined without more extensive field work. The first task of the contractor will be to collaborate with Russian counterparts to develop a detailed project design.

Objectives

The objective of this technical assistance is to support the Russian government in its efforts to improve the workings of its intergovernmental fiscal system. The general approach to be taken in this work is collaborative and supportive. Clearly the lead must rest with the Russian government. The foreign advisors will play a technical role, and will bring international experience to the work. The program could be seen as having four objectives:

- To assist in a comprehensive review of the intergovernmental fiscal system, and the design of a new system of fiscal federalism. The results of this review, and analysis of alternative reforms, should be suitable to support the deliberations of a government commission appointed to recommend reform of the intergovernmental fiscal system.
- To develop a Fiscal Analysis Unit that would be responsible for fiscal planning and fiscal impact analysis.
- To assist in the development of a modern fiscal management information system, analytic models, and a training program that would support the analytic work necessary in a modern fiscal system.
- To assist selected oblasts in developing fiscal analysis units, supported by proper models, data-information systems, and training.
- To improve and modernize the fiscal administration and budgeting systems.

Activities Under the Program

The following are the activities proposed under this program.

Fiscal Analysis Unit. The project will support the development of the Fiscal Analysis Unit through training and collaborative research. A special high-level training program will be developed for this unit. It will include short and long term training, and much of the training will be out of country. The output of this activity will be a functioning fiscal analysis unit capable of leading the fiscal planning work in the future. The Russian government may finally choose to establish more than one fiscal analysis unit.

To support the fiscal planning work of the FAU, the technical assistance would:

- **Develop and implement a revenue forecasting model for the MOF. This would include software development for forecasting the VAT, enterprise income tax, excise taxes, customs duties, and the individual income tax at the central level (total revenue in the country).**
- **Develop revenue estimating capabilities. This would include estimating the impact of changes in the tax code and in sharing rates. The software should enable the analysts to determine the impact of changes in each region of the country.**
- **Expenditure forecasting software and methods should be developed in the Fiscal Analysis Unit. These models should allow estimation of the effects of changes in the assignment of expenditure responsibility at all levels of government.**

Comprehensive Review. A comprehensive review of the present system of intergovernmental relations will be carried out by the Fiscal Analysis Unit and the technical assistance team. This review will cover at least the following issues:

- **The expenditure responsibilities of subnational governments will be itemized and quantified, and the financial implications of alternative expenditure assignments will be evaluated.**
- **A survey of enterprises will be undertaken to measure the fiscal impacts of the transfer of responsibility for social services from enterprises to local governments.**

- A quantitative analysis and evaluation of all shared taxes and subventions will be carried out, and evaluated against the option of tax assignment.
- Locally levied taxes and charges will be surveyed and evaluated.
- A draft White Paper on Fiscal Federalism, under instruction from the government, will be developed.

Fiscal Information System and Modeling. The project will develop the data systems necessary to support modern fiscal analysis. The output of this activity will be three data systems:

1. A census of governments that would bring together the fiscal data for federal, oblast and rayon-municipal government levels, and would allow regular analysis. This is a substantial undertaking, in that it involves recording comparable data for every oblast and lower level local government in Russia. The first step in the technical assistance will be to determine the software and hardware, and the design work, needed to produce this data set.

2. An enterprise level sample that would enable analysis of the impacts of alternative VAT and income tax structure changes, on an oblast level. The government and the project would select an "appropriate" random sample of enterprises, and would record relevant information from their balance sheets and income statements, as well as some specific data about their operations. This sample would be repeated every year. The data could be used to simulate the effects of tax structure changes.

3. A data set that would enable the STS to monitor the efficiency of its collections at the local level. Technical assistance here would be directed at streamlining the reporting system used by the STS. Data would be reported quarterly and would include tax bases as well as revenues, and could be used for a variety of administrative and planning purposes.

The technical assistance also will develop the models to be used on these data. The output of this activity will be a set of models (software, etc.) that can be regularly used and updated without external assistance. The models developed will be of three kinds:

- Straightforward revenue and expenditure estimation models that can be used in capital budgeting and long term fiscal planning.

- A microsimulation model of individual taxpayers (enterprises in this case) that can be manipulated to estimate fiscal impacts. The technical assistance will select the sample of enterprises, develop the model, and train the FAU in the use of the model.
- A simulation model of subnational governments, developed to help estimate the impact of changes in fiscal policy on equalization, etc. The technical assistance will develop the software, make the models operational, and train the staff in the use of the models.

Oblast-Local Fiscal Relations. The technical assistance will support an oblast level analytic upgrading with much the same tasks as described above: modelling, data systems and staff training and upgraded procedures for fiscal planning. This work would be carried out, simultaneously, in from one to three provinces.

The contractor will establish an office in the selected oblast(s) and will undertake the following activities:

- The development of an oblast level Fiscal Analysis Unit.
- A comprehensive review and evaluation of the intergovernmental fiscal system in the oblast.
- The development of a fiscal information system.
- The development of models suitable for revenue and expenditure forecasting, fiscal impact analysis, and analysis of the effects of oblast policies on individual local governments.
- Experimental analysis of local revenue options, *e.g.*, user charges, surcharges on national taxes, and autonomous local taxes. The Russian government may reach the decision that local government units will be given more fiscal autonomy. If it is decided that local governments are to be given more autonomy in the area of local taxation, then technical assistance will be necessary in the area of tax administration in the use of surcharges on various federal taxes, and user/benefit charges. The project could provide technical assistance in this area in the form of experimental programs in selected oblasts.

Property Taxation. The Russian government requires technical assistance in evaluating the options for a strengthened property tax. The technical assistance can be carried out at two levels. In year one, the contractor will work with the federal government in surveying and evaluating property tax practices in the nation, and in addressing the following issues:

- An evaluation of the various options that would seem to be open for changing the rate and base of the tax, and for increasing the intensity of its use.
- An evaluation of the existing database to determine whether there is some possibility to move to even a rudimentary value-based tax. Technical assistance will include an assessment of the data analysis, programming, and provision of computer capacity necessary to utilize this information effectively.
- An evaluation and coordination of the pilot projects now underway. The goal of this evaluation would be to come to some conclusion about the kind of cadastre that Russia should develop.
- Technical training in property tax administration, including: Data collection and management, appraisal techniques, billing and collection procedures, provision of taxpayer information and handling of appeals, and administrative issues such as planning, budgeting and personnel management.

Once the property tax structure has been dealt with, it may be possible to experiment with implementing a reformed system. If the government would accept this approach, a single oblast could be designated for such an experiment, and the project would work with the oblast administration to implement the new system. A resident advisor in property tax administration, perhaps working within a single rayon, could assist in bringing up the identification and registration, and assessment of properties under a new system.

Budgeting and Financial Management. Technical assistance in the budgeting area will concentrate on five areas: First, training in all aspects of budget preparation, execution and review. This should take place both in Russia and in the US. It is recommended that three

classes of up to 50 Russian budget officials each spend 6 months to one year in the US in a university or in a government budget office. In addition, resident experts should offer short courses in Russia, and coordinate training activities.

Second, upgrading the procedures used in the practice of budgeting in Russia. This would involve first sending teams to Russia to flowchart the budget process at the federal, oblast and rayon levels of government. Following this review, and its consideration by the government, a revision of the budget preparation, execution and review process might be considered. Depending on the wishes of the government, the contractor would then undertake a revision of the process beginning with some experimental activities in specified oblasts.

Third, the review team would also survey software and hardware needs, and would assist the Russian government in developing suitable short and long term plans in the budgeting EDP area.

Fourth, as the government develops its new Treasury function, the possibility of supporting USAID technical assistance will be considered.

Fifth, the technical assistance should increase the capacity of the government to use the budget for planning purposes. The contractor should develop a program for training and procedural improvements in the areas of capital budgeting, program evaluation and cost/managerial accounting.

EDP Survey. The contractor will undertake a survey of the EDP needs in the fiscal area. The specific areas of concern are the support for the fiscal information system at the MOF and STS levels, and budgeting. The recommendations of other donors, and the plans of the Russian

Government will be reviewed, in terms of both software development and hardware needs. The contractor will undertake a survey of personnel expertise and make recommendations for training needs. It is anticipated that critical training areas will include training in operating systems, application development in a database environment, software engineering methodologies (*e.g.*, the use of CASE tools), and quality assurance.

A most critical need is the development of a long term computerization plan that will guide all future computerization efforts in the fiscal area. The contractor will work with the government in the development of this long range computerization plan. This plan must address standards for hardware, operating systems, networking, and database software that will be used to implement fiscal information systems. Furthermore, methodologies for implementing this software must be defined. Computerization project management procedures and a standard for project management software must be defined. The contractor will assist the government in defining these methodologies, procedures and standards. Finally, a quality assurance plan must be established to guide the testing and acceptance of all software for fiscal information systems.

The contractor will assist the government in identifying the applications that are most critical to improving fiscal planning within the government. (Coordination with other donor projects already in progress is essential in order to guarantee the compatibility of all computerized systems within the government.) For these initial fiscal applications, the contractor will define the software requirements, procure the necessary hardware and systems software, develop and document the software, and develop and deliver training courses on the computerized applications. The long term computerization plan will provide the standards and methodologies used by the contractor in implementing these computerized fiscal applications.

Training. Because the fiscal federalism reform in Russia will be so dramatic a shift, it will require the support of a substantial training program, including:

- Formal classroom, and "experience" training in the US.
- Training of "Trainers" for Russian based courses.
- Short courses offered in Russia by US experts.
- Study tours.
- Conferences and special seminars, both in Russia and abroad.

It is anticipated that this training will be done through a combination of a US university, a US government institution, and a Russian training center. The programs should be tailored for the Russian participants. The Russian participants should not be inserted into an ongoing program unless it can be shown to exactly fit their particular substance and language needs. The general approach to be followed in selecting a candidate for training is to consider professional skills, experience and aptitude for this kind of work rather than language ability. It should be expected that most classes will be taught in Russian, and adequate provision should be made for the translation of course materials. A preliminary version of the amounts of training expected to be delivered is outlined in Table 1.

Table 1
TRAINING PROGRAM
(persons/months)

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>
Fiscal Analysis Unit	25/12	25/12	25/12
Ph.D. Level Work	50 students with 4 year scholarships		
Budgeting	50/12	50/12	50/12
Senior Study Tour	25/1	25/1	25/1
Special Seminars	TBA	TBA	TBA

The following are the basic content of the courses of study which the contractor is expected to arrange.

1. **Fiscal Analysis Unit.** The fiscal analysis unit at the federal level would be composed of about 15 persons, including those who manage the data. There may eventually be two such units. The oblast level FAU would have a staff of 3-5 depending on the size of the oblast. The training program should accommodate 25 students per year, in a one year program, for each of three years. The course of study should include principles of taxation, fiscal federalism, expenditure analysis, fiscal policy, forecasting and analytic skills including the uses of fiscal modelling. The course should include a mix of theory and practical experience, and should draw heavily on the practice in other countries. The course should include training in the use of large data sets, and hands-on microcomputer applications should be included. An early duty of the contractor will be to develop a complete outline for this course. The contractor should also develop a plan for recruiting students, and provide specification of the qualifications for entry to the program.

2. **Graduate Study in Public Finance.** A number of Russians should be sent to US universities for graduate study in economics with a concentration in public finance. They should follow the normal curriculum, and specialize in intergovernmental fiscal relations. Each student should be given a research experience, either by assignment as an assistant to a research project, or by establishment of a special program for them. They should gain skill with doing policy research and with modern techniques of quantitative analysis. The objective is for these analysts to bolster the ability of the Russian government to draw on the universities and on local research institutes to provide backup fiscal analysis. It will be necessary for these students to be fluent in English. It is anticipated that a group of 50 Russians will be given four year scholarships to complete Ph.D. level work. The contractor will select appropriate Universities for these students, and make all arrangements. The economics departments concerned should be asked to propose curricula and research programs.

3. **Budgeting and Financial Management.** The budgeting/fiscal management group training would take place in a combination of a university/government office setting. The program should provide both. It would be a classroom lectures on budget concepts, and applied work. About 50 students per year in a three-year program would be accommodated. Some of these would return to work in government budget offices and some would become trainers for in-country courses.

4. **In-Country Training.** The contractor will be expected to deliver a substantial amount of in-country training in both general public finance and in budgeting. The course will be taught in part by those who are involved in the training programs in the US, and in part by the contractors. The contractor will establish a relationship with Russian training institutions, and will develop a plan to enhance the capabilities of that institute. Approximately 200 participant months of training per year will be offered in Russia during the three-year term of the project.

5. **Senior Study Tours.** Senior officials usually cannot be released from their duties for more than one month at a time, but their familiarity with western federalism is essential. The contractor will provide short study tours for these senior officials to gain some familiarity with the US and Canadian system. The contractor should consult with the World Bank about the highly successful study tour of this type which it organized during the summer of 1993. It is proposed that 25 federal and territorial officials take part in these study tours each year.

6. **Special Seminars.** Each year, a high level seminar will be held in Russia to familiarize Russians officials with a major issue in the fiscal federalism area, and to discuss the Russian situation. This will take a retreat format and will involve papers presented by western experts and by project team members. The objective of the seminars is to get more active, high-level involvement in the work of the project. The seminars may be held outside of Russia if it is thought necessary. The contractor will be responsible for organizing these seminars.

Estimated Level of Effort

Until the details of the project are agreed upon with the Russian government, it is not possible to give a firm estimate of the level of effort required. The first task of the contractor will be to develop a precise scope of work and a detailed level of effort to support this work. The person/years shown in Table 2 are estimates of the level of effort required to deliver the project as described here.

Table 2
ESTIMATED RESOURCES NECESSARY TO PROVIDE TECHNICAL ASSISTANCE
IN INTERGOVERNMENTAL FISCAL RELATIONS

<u>Activity</u>	<u>Person Years of Effort</u>	
	<u>US Advisors, TDY</u>	<u>US Advisors Resident</u>
1. Comprehensive Review and Fiscal Analysis Unit	7	3
2. Fiscal Information System		
Census of Governments	2	3
Enterprise Sample	1	2
Collection Efficiency	1	2
3. Modeling		
Forecasting	1	
Microsimulation/Enterprises	4	3
Simulation/Governments	2	3
4. Oblast-Local Relations ^a	4	2
5. Budgeting and Financial Management		
Procedures, Survey Work	2	2
Oblast Level ^a	1	2
6. Training Advisors	3	1
7. Property Tax ^a	1	2
8. Hardware/Software Assessment	1	0
9. Home Office		
Project Director	3	-
Resident Director		3
Administrative Director	3	
Associate Director	3	

^a Assuming that there is only one experimental oblast.

II. REVENUE SHARING AND TAX ASSIGNMENT

INTRODUCTION AND SUMMARY

The system of revenue sharing and tax assignment in Russia is described in great detail in the World Bank report, Intergovernmental Fiscal Relations in the Russian Federation, and in an earlier version of this report. The description and analysis in those reports are only summarized here.¹ In the next section, the problems with the system of federal-oblast relations are described and reform options are discussed. The topic in the second section is oblast-local revenue sharing and local taxes. In each of these discussions, a program of technical assistance is outlined.

FEDERAL-OBLAST REVENUE SHARING

Federal governments may choose to share revenues with subnational governments in several ways: grants or subventions, tax sharing on a derivation basis, the assignment of certain tax revenues to subnational governments, and the allocation of borrowing powers to subnational governments. The Russian system uses all of the first three measures to some extent, but the system is dominated by derivation-based tax sharing, *i.e.*, subnational governments are allowed to retain a specified percentage of the tax collected within their boundaries. All of the major taxes are central levies, and subnational governments have little or no discretion to alter the tax rate or tax base.

¹ In some sections of this report, we have borrowed liberally from the Bank manuscript.

Problems and Issues

The present system of revenue sharing is partly inherited from the past, and it is partly an *ad hoc* system designed to accommodate the transition period. In 1992, the federal government did pass a new law establishing the "Basic Principles of Taxation." This system was based on assignment of taxes: the federal government would receive all revenues from the value added tax, the subnational governments would receive all revenues from company and individual income taxes, and the distribution of excise taxes would remain as at present. There was no provision for equalizing subventions. However, the Basic Principles was never implemented, and at present there seems no inclination to move ahead with this program.²

Assignment Versus Sharing. There is considerable interest in moving ahead with some form of assignment of taxes, but it is not clear what form this could take. The complicating factors are many: (a) The tax system is administered by a federal agency, and it would have to act as a collection agent for the subnational governments in the event of assignment; (b) The enterprise income tax would need to be prorated among oblasts once enterprises established locations in more than one oblast; and (c) Adequate revenues would have to be guaranteed to poorer oblasts, *i.e.*, assignment would be counterequalizing.

Tax assignment to some degree is almost certainly in Russia's future, but there are many versions of tax assignment to be considered. One possibility is independent taxing power for each oblast. The World Bank described a version where subnational governments could piggyback on to central taxes, *i.e.*, tax base sharing. Another possibility would be to give rayon

² There is an extensive analysis of the potential impacts of the Basic Principles in the World Bank report.

level governments substantially more autonomy with user and benefit charges, and with the local property taxes. All versions would probably rely to some extent on equalizing subventions.

The Russian government is looking for a more permanent structure that will satisfy the needs at all levels of government, but there are many pulls that make the choices difficult. Thus far, the government has adopted a short term strategy. Over the past twelve months the system of taxation and revenue sharing has undergone numerous changes. There have been two major tax reforms, expenditure assignments have been altered dramatically, and the tax sharing rates have been changed several times. The failure to establish a stable fiscal system has either created or exacerbated a number of problems, as described below.

Lack of Correspondence Between Revenue and Expenditure Needs. There does not appear to be a correspondence between the revenues assigned to the subnational level of government and their expenditure responsibilities. If the present system of tax sharing leads to an overassignment of revenues to the subnational governments, there is no provision for an extraction back to the center; and if it results in underassignment, there is no automatic provision for a subvention to make up the difference. The present transitional system leaves it to the MOF to resolve any revenue shortfalls by negotiation of variable sharing rates and the provision of subventions.

The underlying problem here is that decisions about revenue assignment have preceded decisions about the assignment of expenditures, and seem to be independent of any assessment of expenditure needs. Surely the essential first step in deciding the division of revenues is to understand the fiscal implications of expenditure assignment. "How much will it cost subnational governments to carry out the expenditure responsibilities they have been given?" The recent

transfer of expenditure responsibilities for consumer protection to the subnational level with neither quantification nor corresponding shift in revenue shares, is a dramatic example of what happens when revenue and expenditure assignments are not considered together. This mismatch will continue, since there is no reason to expect correspondence under the present revenue sharing rules.

The concept and measurement of fiscal surplus or deficit are not well developed in Russia, and so it is difficult to use the data to determine the fiscal health of territorial governments. Ideally, the surplus or deficit should be measured as the difference between revenues raised from shared taxes, and expenditures required to finance an "adequate" level of services. Subventions should not be included in the initial measure. Moreover, the meaning and policy implications of fiscal health of the aggregate sector, and the disparities in fiscal condition across territorial governments, must be clear in the minds of those who design and implement the fiscal system. In short, the Russian system of measuring and analyzing fiscal health is in need of revision.

Equalization. It is inevitable that a country so large and diverse as Russia will have substantial fiscal disparities. There are great differences in economic structure, population composition and natural resource endowment that will be reflected in fiscal capacity and expenditure needs. It is essential that the Russian government have a policy to address these disparities, and a system in place to measure and monitor them. There is no reason to expect that the system of tax sharing presently in effect is equalizing, *i.e.*, that it allows oblasts with lower fiscal capacity (relative to needs) to retain larger shares. The enterprise income tax, shared on a derivation basis, can be expected to favor higher-income oblasts that have more active

economies, and those in which government investment in enterprise development has historically been very heavy. The same is true of the individual income tax, which is based on the size of payrolls in enterprises. The VAT could have an equalizing or a counterequalizing distribution because it is distributed by the federal government on an *ad hoc* basis. The same may be said about central government subventions awarded outside the shared tax system.

Empirical analysis carried out on 1992 data as part of the World Bank report, and by Bahl and Wallace,³ indicate that neither the tax sharing system nor the subvention system are equalizing. In fact, the results show that higher income oblasts retain higher per capita levels of tax, and that these disparities in fiscal capacity are widened further by the distribution of subventions.

Administration. The revenue system is administered by a federal agency, the State Tax Service (STS). It was formed in 1990, mostly with former employees of the oblast, city and rayon government finance departments. The system features federal, oblast and local offices, but with a substantial amount of operational independence at each level. In theory, there is a vertical reporting hierarchy, but in practice it is not clear how cleanly the ties between the STS and the local administration have been severed.

There are merits and drawbacks to centralized tax administration, and the weight of these will depend largely on the kind of revenue sharing/tax assignment system which is chosen for the federalism. For the present, the intent seems to be in the direction of holding of a centralized

³Bahl, R. and Wallace, S. *Revenue Sharing in Russia*. Policy Research Center and Economics Department, Georgia State University. Presented at TRED Conference, Cambridge, MA, October, 1993.

tax administration. There are merits to this approach: economies of scale in training, procurement, software development, and the possibility of standard assessment and collection procedures for the central tax system. There also is the advantage of having a cadre of tax administrators who are independent of the local political process. At present, there does not seem to be a major push for decentralized and autonomous tax administration.

This is not to say that there are not major problems with the present system. Problems during the transition period are to be expected, in part because of the "newness" of the tax system to both administrators and taxpayers. Some legislators and officials speculate that collection rates may be as low as 40 percent, but STS officials point out that no hard evidence supports this guess.

Among the more often cited problems are:

1. The central system of tax administration is relatively new.
2. Some longstanding flaws in the system of tax administration have been magnified by the recent economic liberalization program. These flaws include uncertainty about the tax treatment of wages and social service expenditures under the enterprise income tax, and inadequacies in the books of account of enterprises.
3. STS local officials are not certain about the details of the tax laws, and there have been two major reforms in 1992.
4. There is an inadequate staff to carry out the tax administration duties assigned.
5. Computerization of the tax administration system is in its infancy, and procedures for assessment, collection and audit are dated and not efficient.
6. Enforcement problems are especially serious for the self-employed. Records of liability are incomplete, collection efforts are not aggressive, and penalties are insufficient.
7. The link between the STS and the local governments are strong enough in some cases to where the tax laws may be compromised. There are many examples of subnational governments making adjustments to the existing tax laws and to the rules for revenue sharing, and some oblasts also are reported to be withholding payment of large sums to the federal sector.

8. The Banks have withdrawn from the process of channeling the shared taxes to the appropriate level of government, and this has caused problems with the revenue sharing system.

Revenue Mobilization. An objective in the design of any multitiered system of government finance is to give the subnational governments an incentive to increase their rate of revenue mobilization. In Russia, this might happen in one of several ways:

- Subnational taxes and charges might be levied at higher rates and on a broader base.
- Subnational governments might influence the vigor with which the tax system is enforced.
- Subnational governments might stimulate the profit-making objectives of the enterprises they own.

Whether the present system stimulates or dampens revenue mobilization is an open question. On one hand, subnational governments retain only a fraction of what is collected; hence they may have little incentive to promote collections aggressively. This would seem especially true in the case of those territories that retain only 20 percent of VAT collections. Subnational governments may also expect that any shortfall will be made up by a deficit grant and this tends to dampen enthusiasm for an aggressive enforcement program. It is arguably true that local governments have some ability to effect the collection rate through their influence over the local STS offices, and there is a strong relationship between the local governments and the enterprises that constitute the largest component of the tax base.

A contrary argument can be made, *i.e.*, that the present system does encourage revenue mobilization by subnational governments. The retention rates are large for both individual and enterprise income taxes, and many territories retain half of all value added collections.

Subventions are available, but they are negotiated yearly and are by no means certain in amount. Moreover, there is the point that the STS is increasingly independent of the local government and it may not be possible for local authorities to influence collection rates.

The World Bank Study, and the later analysis by Bahl and Wallace, treated this issue as an empirical one, and analyzed the relationship between the level of revenue mobilization by oblasts and the share of revenues they were allowed to keep. The results do not show that oblasts with higher retention rates acted on this incentive to make a significantly greater tax effort.

Fiscal Planning and Information. If the federal government is to design and monitor the intergovernmental fiscal system, it must understand the impacts of federal fiscal decisions on subnational governments, it must have an early warning system to detect problems, and it must be able to design compensating adjustments when the system fails. It is a major problem with the present system that the information system available will not allow these goals to be achieved.

1. There is no systematic approach to estimating the impacts of proposed central changes in the tax system or the revenue sharing system on individual governments.
2. There is no forecasting system in place that can anticipate fiscal outcomes in the middle or longer run.
3. The STS has no set of indicators that will allow detection of changes in collection efficiency at the lowest level of government.
4. There is not a trained staff whose primary focus is on longer term fiscal planning and system design.

Fiscal Planning and Coordination. There is no central place where responsibility for fiscal planning rests. This is not so unusual in a country where there is a strong Parliament and Presidency, *e.g.*, in the US, the Treasury, Congress, and the Congressional Budget Office often disagree on the impact of a proposal. But Russia is different in that there is a paucity of such analysis, and there is no mechanism whereby the various sides come together to debate the issues.

A fundamental problem is that there is not a strong support that is skilled in modern techniques of fiscal analysis and supported by adequate information and models for impact analysis and forecasting. Much of the analytic work is done in an *ad hoc* way.

Macroeconomic Policy. Does the present system of intergovernmental fiscal relations compromise the ability of the central government to formulate and execute macroeconomic policy? Three issues might be considered in this respect. First, do subnational governments have so much latitude to adjust tax rates and bases as to offset central government goals for the allocation of resources (as, *e.g.*, between public sector "consumption" and investment, and between public goods and private goods)? In Russia today, if subnational local governments cannot adjust the rate or base of any major tax, they cannot significantly affect resource allocation in this way. The enterprise income tax is one exception to this rule, and in this case, the rate may be adjusted downward from 32 to 30 percent at oblast discretion. However, the subnational government must bear the revenue loss resulting from the rate reduction. The other exception is the possibility that local taxes "crowd out" the federal tax base. In none of the local areas visited did this appear to be a major issue.

A second issue is whether the present tax assignments compromise the budgetary position of the central government and whether the revenue stream dedicated to subnational governments is so large as to prevent the central government from meeting its needs without a budget deficit. In fact, subnational governments do exert a significant claim on federal revenues. The subnational government claim on shared taxes now accounts for more than one-third of the total revenue collections of the government.

Third, there is the possibility that local government expenditure decisions will compromise the investment and maintenance plans of the central government. In fact, subnational governments are given considerable latitude in shaping budgets, and though there are some mandates, it is possible that local expenditure decisions will not match central priorities.

Options for Reform

The problems with the present system of revenue sharing and tax assignment would seem substantial enough to call for a comprehensive review of the system, with an eye toward a major restructuring. The government has discussed this on many occasions, and the writing of the "Basic Principles" was a step in this direction. A comprehensive restructuring was also a recommendation of the World Bank report. A transition period may be necessary, but it is important to move toward a more transparent system that reflects the longer term policy objectives of the government.

There are a number of reform options to be covered in a comprehensive review:

- Reviewing the possibilities of various forms of tax assignment. This could lead to establishing some degree of local taxing authority.

- The development of a grant system, less *ad hoc* and more consistent with government objectives for equalization and local revenue mobilization.
- Evaluation of the possibility of granting some degree of local borrowing powers, and reviewing other possibilities for capital finance.
- Strengthening local property taxation.
- Allowing different degrees of fiscal discretion for larger versus smaller cities.
- Increasing use of benefit and user charges.

Possible Technical Assistance

USAID might consider offering the Russian government technical assistance in the fiscal federalism area. The assistance could have three objectives, all consistent with the stated goals of the Russian government:

- To do a comprehensive review of the present system of tax assignment and revenue sharing, to evaluate options, and to design a workable system for the future.
- To put in place a continuing capacity for fiscal analysis.
- To develop the capacity of the State Tax Service to evaluate the performance of the tax administration in individual oblasts.

Comprehensive Review. A comprehensive review of the system would be a major undertaking. It would involve an analysis of each facet of the revenue sharing system. The following are some of the topics to be covered:

1. A quantitative analysis of each of the shared taxes in the present system in terms of their distribution across oblasts. The objective would be to establish the extent to which they are equalizing, whether or not they dampen revenue effort, and their revenue elasticity. This would provide a baseline against which to compare tax assignment.

2. A similar analysis of the distribution of subventions.
3. A thorough evaluation of locally levied taxes in the present system, and an analysis of their actual use in various parts of the country.
4. An analysis of natural resource revenue sharing.
5. A study of the special fiscal issues facing the largest cities.
6. An assessment of the administrative difficulties associated with the present system.

In every case, the analysis would be quantitative and based on primary data. The most modern techniques of fiscal analysis would be used, and the experience in other countries would be drawn on extensively. The overall objective would be to come to some conclusion about the efficacy of the present system, or a variant of it, as a long run solution in Russia.

The second part of the review would turn to the tradeoffs implied if a different system were chosen. Again the analysis would be quantitative and would draw heavily on the successes and failures in other industrialized countries. Among the special analyses to be carried out are:

1. The implications of a tax assignment versus a tax sharing system.
2. The feasibility of a less *ad hoc* set of subventions, and the possible effects on various types of oblasts.
3. The possibilities and potential impacts of more autonomy at the local government level, *i.e.*, the authority to levy taxes and to alter user charges without federal approval.
4. Alternative methods of capital financing for subnational governments.
5. Implementation problems and costs associated with each reform.

Finally, the review would consider implementation issues. It would consider the implications of designing an equalizing grant system, and the kinds of monitoring support and data gathering that would be needed to operate it. It also would develop the steps necessary to operate a tax assignment system, *e.g.*, how to make the STS accountable to the subnational

governments, how to deal with enterprises who have more than one location in the country, and what limits to place on local taxing autonomy. A function of this work would be to suggest a transition plan to ease the implementation costs and problems.

The result of this work could be a White Paper on Intergovernmental Fiscal Relations that could be debated in Parliament and by the government. It could be the basis on which a new system could be developed for the post-transition period.

Fiscal Planning. The second activity under this technical assistance, and really the basis for the comprehensive review, is to assist the development of a continuing capability for fiscal analysis and planning. The technical assistance could lead to three tangible results:

- The establishment of a fiscal analysis unit within the government. The members of this unit would be trained in the most modern techniques of final analysis, and would be principals in the comprehensive review of the system.
- The development of a full fiscal information system. Each year, there would be a reporting of all tax and expenditure data by each subnational government in the country, in a comparable format. These data would be placed in machine readable form for ease in analysis.
- A series of models would be developed to allow the government to develop estimates of the impact of various policies on individual subnational governments, and on the sector as a whole.
- The development of a sample of enterprise taxpayers, that would allow the FAU to estimate the impact of any proposed tax reform on individual oblasts.
- The development of modern models to use in revenue forecasting over the medium term.

STS Assistance. The State Tax Service is responsible for the administration of the tax system, but they are an important element of the intergovernmental fiscal system in Russia. This

is because of their close working relationship with the local governments, and because the STS collects the taxes for all levels of government. It is necessary that the technical assistance to strengthen fiscal federalism involves the STS.

To the extent the final solution in Russia involves some shared taxes, and it is almost certain that it will, it is crucial that the STS be able to make estimates of revenue collections for individual oblasts and for some lower level governments. It is also important that the STS be able to monitor the efficiency of collections at the local level, and to estimate the impacts of any change in federal tax policy or administrative procedure.

The technical assistance should take the form of upgrading the present tax reporting system for each subnational government. Computerization and more rapid transfer of these data, and some work on making the data more comparable, could greatly enhance the capacity of the STS to assist in the fiscal planning exercise. It would also be necessary to provide training and model development to take advantage of this improved information system.

OBLAST - LOCAL RELATIONS

The oblast Soviet is responsible for the allocation of financial resources among the rayons and municipalities within the oblast. It determines the share of taxes that may be retained by each local government (and by the oblast government), and it may choose to allocate an additional subsidy to local governments. It therefore determines the level of spending by each local government.

In making these decisions about intra-oblast fiscal relations, the oblast Soviet has a great deal of discretion. It is, however, locked into some constraints:

- The rates and bases of all major taxes are fixed by the federal government and may not be adjusted.
- Some minor taxes and charges are prescribed as fully local, and local (usually rayon) governments may set the rates.
- A National Law, passed in April of 1992, prescribes revenue sharing from petroleum and specifically mandates the local (rayon) share. In Tyumen Oblast and Khanti-Mansisk Okrug, for example, the prescribed sharing is okrug (30 percent), rayon (30 percent), federal (20 percent), and oblast (20 percent).

There are two very great advantages to this decentralized approach. First, it gets the central government out of the business of having to make fiscal decisions concerning the revenue needs of thousands of local governments. Second, it makes the oblast Soviet more accountable to the local population for the results of the fiscal decisions made. Third, it clearly is a step toward fiscal decentralization in that it brings government decisions "closer to the people."

Issues and Problems

A number of problems emerge as a result of intra-oblast revenue sharing. The need to equalize fiscal capacity within the oblast, the problems with stimulating local revenue effort, the certainty with which local governments may plan their budgets, the need for increased local autonomy, and the special problems with the "place of employment" allocator for the individual income tax, are all issues that are under discussion.

Fiscal Disparities. There are wide variations in economic well-being and in fiscal capacity within each oblast. For example, within Ryazan Oblast (which has 13 rayons and 2 cities), per capita expenditures were more than three times larger in the highest spending locality than in the

lowest. Per capita expenditures were 50 - 100 percent greater in the city of Ryazan and in the city of Skopin than for the average of all Ryazan's rayons.

The enactment of equalization features in the revenue sharing system by the oblast Soviet raised some tensions with the better-off local governments -- particularly the urban centers -- who feel that they are unduly discriminated against to underwrite equalization. The situation is made more complex because there are also very great public service needs in the urban areas. At present, at least some oblast governments have opted to use flat-rate tax sharing (which is counterequalizing) along with equalizing subventions.

Revenue Raising Efforts. A second, and closely related, problem is that the need to equalize may tend to dampen efforts to increase the rate of revenue mobilization. In some cases, the STS staff is closely linked with the local governments (rayon and cities), and assessment and collection efforts at the local level may be less successful (perhaps less vigorous) if the local community does not see that it will receive an adequate return from its increased revenue effort.

Both of these issues point at a major underlying concern -- that oblast Soviet decisions may not reinforce central government economic policy. One can best illustrate this with an example. Suppose that the central government decided to base its economic growth strategy for the next ten years on the development of urban centers and on the development of those industries that require skilled labor and infrastructure at a certain level of provision. Under the present system, the central government could not easily implement this strategy. The oblast Soviet could still choose to allocate resources away from the urban and towards the rural areas, and could choose whatever focus on education that it wanted. This illustrates a major

characteristic of strong subnational governance. In truly decentralized systems, the central government loses considerable control over the implementation of macroeconomic strategies, by definition.

Planning Certainty. A third problem with the present system is certainty. Oblast and lower level local governments need to know the revenue flow coming to them with enough certainty to plan their budgets. The present revenue-sharing system has been changed markedly during 1992, and efficient fiscal planning has been virtually impossible. And because the tax sharing is done on a derivation basis, the oblast Soviets have changed the intra-oblast fiscal arrangements with each change in the federal formula.

Local Autonomy. Fourth, even leaving the decisions on fiscal distribution to the oblast Soviet is not enough for those who are the strongest advocates of fiscal decentralization. They would argue to give more autonomy to the local (rayon and municipal) Soviets. After all, the oblast may have several millions of population and the oblast Soviet may not be in tune with the needs of the local population. The local Soviets are closer to their people and the problems, and to those who must ultimately pay the taxes to support government expenditures. Thus far, the lowest-level Soviets have not been given much say in determining the level of the local budget.

Derivation-based Income Tax. There is a special problem with the allocation of the individual income tax. At present it goes fully to the place of collection -- where the job is located. Because none of the revenue goes to the place of residence, a mismatch is created

between the rayon where a worker uses services (e.g., education, health) and the rayon that receives the tax paid by him. This is a difficult problem, not unknown in other federal countries, but it has been successfully addressed with various forms of revenue sharing schemes. Commuter taxes, differential rates for residents and commuters, compensations, and state assistance are a few of the possibilities.

Reform Options

The government is at a crossroads in deciding how to deal with intra-oblast relations. The "Basic Principles" law is ambiguous on this issue. At present, allocation choices rest with the oblast governments, and some have opted to redistribute substantial amounts of revenues away from the urban centers to the less developed rayons. The issue has become contentious, and calls have been made for a federal formula that identifies the share of each local government, either to enhance the position of the rural rayons or to protect the larger revenue base of the cities.

In general there would seem to be three strategies:

1. A traditional federalism could be created where taxes are assigned to either the federal or the oblast level and the oblast could then decide on the distribution among the local governments;
2. An exact allocation of fiscal resources could be prescribed by the federal government for oblasts, cities, and rayons; or
3. General guidelines, and some mandates, could be given for distribution within the oblast.

There appear to be advocates of each of these three possible strategies. Centralization (item 2) may be the least desirable of these alternatives. In a country so large and so diverse as Russia, it is unrealistic to believe that public servicing needs for every local area can be properly assessed from the center. Moreover, the central government is ill-equipped to undertake such a

task. There is not a full information system to describe the fiscal situation in local government areas, and there is no capability to monitor the fiscal outcomes in local areas. Perhaps the greatest drawback is that this would be a step away from fiscal decentralization, and would make local-level officials less accountable for their fiscal decisions. Thus the view taken here, consistent with the World Bank report, is that federal-subnational fiscal relations should not go below the oblast level except in unusual circumstances.

Continuing with the present framework -- leaving the distribution decisions to each oblast - Soviet -- would seem a reasonable option. It would involve less shock to the system at a time when the system is fragile and undergoing major changes. It would continue to leave accountability for fiscal decisions with the oblast Soviet, and it would be consistent with the reality that certain republics will be given greater autonomy.

The central government may feel that the problems with oblast autonomy in this area are great enough that some adjustments are necessary. There is in fact a new draft law -- "Budgetary Rights of Local Self-Governments" -- on the relationship among levels of government, and this proposes some important changes in revenue sharing and expenditure autonomy.⁴ One basic principle in this law is to give "structure to the relationship between the rayon government and its oblast government." The proposal is that the oblast guarantee funding for 70 percent of the amount necessary to provide a "minimum" level of public services in each rayon. The advantage of this proposal is that it allows the government to set minimum standards in the delivery of some services. It also gives the rayon and city governments some degree of certainty in planning their budgets, since the 70 percent guarantee would be for five years. The disadvantage is that

⁴ The Draft Law passed a first reading in the Supreme Soviet in July, 1992.

mandates restrict the autonomy of the oblast to plan the development of its economy, and that the needs may not be defined in a "reasonable" manner. The implication of this proposal, however, is that the federal government would need a much greater capability to monitor the performance of the subnational governments.

Possible Technical Assistance

Russia's federal system almost certainly will emerge as a three-tier arrangement where federal, oblast and rayon-city will all have important fiscal powers and responsibilities. Technical assistance that is limited to the federal government will only address a part of the issue. Technical assistance should also be extended to the oblast level.

There are three general areas where technical assistance to the oblast governments could be valuable. These are (a) the development of a fiscal analysis unit to lead fiscal planning for oblast governments; (b) the development of a fiscal information system and accompanying models to evaluate fiscal impacts; and (c) the carrying out of some pilot activities in local taxation. The best approach would likely be to choose a small number of "representative" oblasts, and work intensively on these issues. One would hope to develop a set of prototypes.

Fiscal Analysis Unit. USAID could provide technical assistance to develop such a unit for selected oblasts. The functions of the unit would be to carry out the analysis that would inform the decision about revenue sharing within the oblast. The technical assistance could train the officers in the FAU, and work with them in a comprehensive review of the present system

of intra-oblast revenue sharing. The output of this work, in addition to the establishment of this unit, would be a review of the present system and a possible set of proposals for reform.

The members of the FAU would take on several tasks on behalf of the oblast administration and Soviet. They would (a) be responsible for planning the adjustments in response to changes introduced at the federal level, (b) make the annual revenue forecasts for the budget and prepare longer term forecasts, and (c) monitor the equalizing features of the system.

Information System and Models. The FAU would have to be supported by a fiscal data system and a set of analytic models. The technical assistance would design both the information system (in a format that would include standardized sub-formats to be used in all oblasts) and the models and would work with the FAU and the oblast administration in implementing these. The models would be computer simulation modules that would allow the FAU to assess the impacts of various changes under a variety of assumptions. The information system would be a computerized data base, with comparable information from every local government in the oblast. The technical assistance would provide a way for oblasts to upgrade and computerize the system they now use.

Pilots on Local Taxation. Various local governments in Russia have been experimenting with local taxation practices. For example, many levy the property tax at rates that are not authorized. There almost certainly will be a call for more local taxation as part of a decentralization program, and pilot studies could help to design prospective local tax instruments.

The property tax is a good candidate for a local tax. It is suitable as a local tax because its burden is mostly borne by local residents, and local officials have a comparative advantage when it comes to administering this tax. USAID could provide international experience to assist in designing a pilot property tax program in one oblast. This assistance could involve the design of the tax structure and of the tax administration.

User charges is another area where a pilot project may be attempted in a single oblast. Technical assistance might be used to help identify areas where benefit or user charges might be levied or increased. The results could be closely monitored.

Local surtaxes are growing in importance in Russia. In fact, many of the 49 local taxes are surcharges. Technical assistance could assist a pilot oblast to develop one or more of these surcharges in terms of both structure and administration.

Of course all pilot activities must involve the permission of the federal government, and by definition a pilot or experimental project means that some deviation from the present law is required.

III. EXPENDITURE ASSIGNMENT AND BUDGETING

INTRODUCTION

The chapter addresses two important issues concerning expenditure planning and control. The first reviews and describes the problems with expenditure assignment in the present system. The second addresses a number of issues related to budget practices. Both sections describe opportunities for technical assistance.

EXPENDITURE ASSIGNMENT AND STRUCTURAL REFORM

General Issues in Expenditure Assignment

The present system of expenditure assignment among levels of government in Russia is to a very large extent the one inherited from the previous regime. On the surface, this system is entirely compatible with the principles of modern public finance in market economies where responsibilities are assigned according to the size of the benefit zone for public expenditures. Thus, those services primarily benefitting local residents, *e.g.*, elementary education, are assigned to rayon and city governments. Similarly, services with benefits jointly reaching residents of several rayons, such as regional hospitals, are provided by oblast governments; and services affecting the entire country, such as research institutions, are provided by the federal government.

In practice, however, the assignment of expenditure responsibilities doesn't live up to these norms. There are three problems. First, the transition period has brought difficult economic and budgetary circumstances, and recent transfers in responsibility from the federal government to the oblast and rayon governments have been primarily to address the budgetary problems of the

federal government. Not only have the reassignments been murky, but they have not always squared with the principles of public finance. Particularly, the assignment of social safety net expenditures to local governments raises some major problems.

Second, local governments could not exercise any significant measure of fiscal autonomy in decision making until 1992. In the previous regime local governments were essentially executors of federal government plans. The potential gains in efficiency coming from the provision of services by more independent decision makers is a benefit that Russian governments are still learning about, and there is much room for the local governments to exercise budget independence. Third, state enterprises played a major role in the provision of social services, and often they also were the main providers of local infrastructure. These enterprise responsibilities are slowly being transferred to the government sector where they belong. This transfer has the potential of putting enormous pressure on many oblast and rayon budgets.

State of Flux in Expenditures Assignment

The assignment of expenditure responsibilities has been in a state of flux over the past several years. One primary reason for the state of flux in expenditures assignment is that none of the laws governing the system of intergovernmental relations in the Russian Federation systematically defines the assignment of service responsibilities among the different levels of government.

Because expenditure assignments are not specified by law, there has been no impediment to the Ministry of Finance to offloading responsibilities on to the local governments when budget conditions so demanded. The pressure exerted on the federal government by international

organization to reduce its large budget deficit appears to have been a significant factor in the offloading of federal responsibilities. Most notably in 1992, several important expenditure programs were shifted to local governments, including the following: consumer price subsidies for milk, bread, meat and baby food; cash subsidies for vulnerable groups; various family allowances; and other social support programs. In the past, many of these programs had been financed with direct grants from the federal program, but since 1992, they have been the financial responsibility of subnational governments.

In 1993, the central government decided to provide significant increases in credits and loans to agriculture, and to provide for an early delivery of goods to Russia's Arctic North. Most of these additional expenditures are being channeled through the oblast governments. As with the offloading of other federal government responsibilities to subnational governments, the additional expenditures for oblasts and rayons are taken into account in the determination of the sharing rates for the "regulating" taxes, at least in the year the offloading takes place. Often, local governments complain about the lack of adequate compensation for the added responsibilities. To some extent, therefore, the offloading of responsibilities by the federal government resembles unfunded mandates.

There are good reasons to explain why a clearer definition of service and expenditure responsibilities has not yet taken place and why it may not take place any time soon. Both the subnational and the central governments see advantages in not having a clearly defined division of expenditure responsibilities. Lower level governments use their wider responsibilities to bargain for a larger share of revenues from the upper-level government. This process goes on in both tiers of intergovernmental relations: the oblasts versus the central government and the

rayons versus the oblast governments. The federal government sees advantage in having the flexibility to shift fiscal responsibilities down to local governments to balance its own budget. These murky divisions of expenditure responsibility have contributed to the survival of the "bargaining" mode of intergovernmental relations inherited from the past regime. But such negotiations are not compatible with defining a federal system of governance where service and financing responsibilities are clear.

Finding some resolution to the problems associated with expenditure assignment, and more generally to designing a workable fiscal federalism, is complicated by the demands for autonomy and the pressures for political devolution aired by some territories inhabited by ethnic minorities. These demands have been louder when disputes about the exploitation rights to oil and other mineral resources are involved. This conflict raises the question of whether special fiscal status should be granted to some of the territories. At present, there are decentralized systems of intergovernmental relations that allow for special regimes within the unified system. For example, Tatarstan and certain other territories have negotiated lump-sum payments in lieu of tax sharing.

Mandates by the federal government are another important source of friction in the division of expenditure responsibilities among the different levels of government. The term "mandate" refers to an order, from an upper level of government to a lower level government, to carry out an expenditure responsibility. The problem is that these mandates have not been funded by the central level.

The most important case of an unfunded mandate took place in 1992 when the central government shifted expenditure responsibilities to local governments for food subsidies and local

transportation. This included subway systems, public utilities, and certain price subsidies. The main rationale for this mandate appears to have been to help balance the budget of the central government. Because of the inability of local governments to finance many of these activities in the longer run, another goal of this set of mandates appears to have been to force the discontinuation of some of these expenditures (e.g., price subsidies) in the public sector.

The shifting of the responsibility for bread, milk, and other foods and medicaments to local governments created enormous budget pressures, and many local governments were forced to discontinue some of the subsidies. The biggest concern about the impact of the unfunded mandate was the crowding-out in local budgets of expenditures on health and education. While it is too early to quantify the impacts, there can be little doubt but that traditional local government expenditures have been affected. The central government has allowed subnational governments complete freedom to fix the subsidies for milk and bread, but the subsidies for fuel and baby food still are determined by the central government.

Another form of central government unfunded mandate was the increase in salaries for local government employees in 1991, although in this case there was some partial funding (R 2 billion in the first two months of 1992). The average wage increase at the local level mandated by the central authorities in the last quarter of 1991 was 90 percent. But, by special Presidential Decree, the increase in the area of education was of 120 percent, and wages in the education sector were linked to the wage level in the "materials sphere." Demands from workers in other areas have responded in an attempt to catch up with education workers. In the case of health workers, there have been recent wage increases with the objective of reaching parity with the education sector.

Oblast governments also can impose unfunded mandates on rayons. Rayon governments often find themselves in the same helpless position with respect to their oblast governments that oblast governments are with respect to the central government authorities. For example, the level of price subsidies are fixed at the oblast level for heating, bread, milk, and meat, but it is the rayon that must pay these subsidies.

Technical Assistance Possibilities

A concrete and stable assignment of expenditure responsibilities is imperative in the development of a well-functioning system of intergovernmental relations. The development of objective rules for expenditure and revenue assignment will allow Russia to move away from the subjective discretion that characterized the previous system of intergovernmental relations. Without it, the Russian Federation will not be able to shed the negotiated mode of intergovernmental relations. Neither the arrangement envisioned in the Law of Budgetary Rights of April 15, 1993, nor the tax assignment in the "Basic Principles" will work in the medium term, if there can be frequent, unpredictable changes in expenditure responsibilities. The lack of a precise definition of responsibilities will almost certainly strain relations between central and the oblast level government. The same exact things can be said about the relationships among the oblast and lower level governments.

What is needed is a systematic, data-intensive approach to the redesign of intergovernmental fiscal relations, where the expenditure responsibilities of subnational governments and their financing requirements are itemized and quantified. This will require an analysis of expenditure responsibilities, function by function; an estimate of their financial

requirements, based on these assignments; and an assessment of the yield of alternative revenue assignments against these expenditure needs, based on a simulation analysis of alternative assignment possibilities. Any transfer of responsibilities, assets, or enterprises, or any central mandate for wage increases and price ceilings would be explicitly modeled and the impact on fiscal balance estimated.

The government should consider undertaking comprehensive review in two areas. First, the responsibilities of the federal government versus the oblasts should be firmly established. To do this, the government must identify what expenditure responsibilities have been misassigned, and among these, which should be retaken by the federal government. This review should be supported by a thorough, empirical analysis of the impact of alternative assignments on both the federal government and on individual oblasts. USAID could support this review with a technical assistance project. Second, the assignment of responsibilities between the oblast and rayon governments should be established. This is a complicated issue since oblasts have responsibility for making certain expenditure assignment decisions, but other local assignment decisions are affected by federal mandate. Moreover, whatever decisions are made about federal-oblast expenditure assignment will have important impacts on oblast-rayon choice. USAID should consider supporting a technical assistance project to identify options and choices in selected "pilot" oblasts. The methodology and findings for the pilot oblasts hopefully will be replicated later on in all other oblasts.

THE SOCIAL SAFETY NET AT THE OBLAST AND RAYON LEVELS

Main Issues and Problems

Substantial responsibilities in the social safety net area have been shifted down to oblasts and rayons over the past two years. In the light of inadequate funding and the increased responsibilities in other areas, there is concern about the ability of local governments to provide these services. Moreover, the Russian Government has declared the social sectors -- education, health, and social protection -- as priority sectors for budgetary allocations, so that they have been spared from the drastic cuts suffered by other sectors such as defense or price subsidies. "Protected" items in the social sector include: salaries, pensions, family allowances and other allowances, medicines and hospital supplies and various subsidies. This is an important mandate that has significantly affected the fiscal autonomy of subnational governments. Fortunately, at present, directors of spending units (hospitals, schools and so on) have freedom to staff their operations in any way they want and therefore are able to generate some additional funds in critically underfunded areas.

There have been important institutional changes which have unburdened government budgets from direct responsibility in several areas of income maintenance. Pensions, financed before by the union and republic budgets, are now financed from an independent extra-budgetary fund. Enterprises contribute an amount equivalent to 35 percent of their payroll to the Pension Fund. In addition, enterprises contribute 5 percent and 1 percent of payroll, respectively, to the Social Insurance Fund and to the Unemployment Fund.

The wider obligations of the subnational governments on safety net issues is for the social safety net and social services recognized by the MIOF in the budget negotiations. However, it

is generally agreed that funding is grossly inadequate. An important reason for this inadequacy is that local governments increasingly have been forced to take over many of the social services formerly provided by state enterprises. Some of the problems for local governments arise from the poor timing of payments by the federal government of previously allocated funds. Similar problems in the timing of disbursements exist for rayons.

Despite the fact that the Russian government has declared the social sectors and safety net priority sectors, there is evidence that these sectors have experienced a steady decrease in real expenditures per capita during the transition period. In the first two months of 1993 alone, the cuts in the social and cultural area are reported to have been the equivalent of one-fifth of the entire government consolidated budget.

Budgetary pressure at all levels of government has made line-item flexibility in the budget an increasingly important issue for the maintenance of real expenditure levels in the social sectors and safety net. Despite the fact that a substantial part of the budget for most oblasts is financed with transfers or subventions from the central government, and that in turn most rayon governments are financed with funds provided by the oblasts, all these governments have line item flexibility. That is, they have the right to reallocate funds across budget categories once the overall transfer and negotiated tax sharing rates have been approved.

For some observers this flexibility is problematic in that it raises questions about the adequacy of social services if subnational governments were to make the wrong decisions. There are some requirements on service standards established in other laws, such as the Law on Education. The question remains whether this legislation can be used to exert enough control to maintain standards of provision for social services and the social safety net. One possibility,

often mentioned in Russian circles, is the introduction of more strict limitations in the budget process *per se*. This, of course, would detract from the generally desirable budgetary independence of local governments.

Another significant problem in the social sector is the unequal endowment of social infrastructure across regions. The importance and severity of the inequalities inherited from the past regime are among the most difficult questions being faced by the Russian Government, and there is no clear answer about what should be done about these inequalities.

There is no inventory of differences in the level of infrastructure across oblasts. However, the different indices of social infrastructure, such as number of hospital beds and schools per capita, show considerable disparities. The historical role played by state enterprises in the provision of social services has contributed to disparities in service levels. Because these expenditures were off-budget, they were always difficult to track. A successful enterprise built housing and schools with "uncommon" facilities such as swimming pools within a municipality where the rest of the population had to live with much less in public infrastructure.

Technical Assistance

The scope and level of technical assistance in the social safety net area will depend on the direction taken by the decentralization process. For example, will the technical aspects of education, such as curriculum, be fully decentralized? How will the health system evolve? Will subnational governments see increased responsibilities in this area or will autonomous entities take over many of the responsibilities in the health services that are now the obligation of oblast and rayon governments?

One important task facing the Russian Government is to develop a data base on the existing facilities at the oblast level in the social sectors (schools, hospitals and so on) and on their physical condition. This information may be used to develop an estimate of needs for public facility investment and maintenance. This is an important area for technical assistance.

Another important area for technical assistance is the design of grants which would effectively maintain or increase needed expenditures in the social sectors and safety net areas by subnational governments.

The difficulty of developing these policies independent of the rest of the budget is well illustrated by the decision of the World Bank not to use a matching grant program to stimulate and maintain social expenditures at the local level. The main reason is the fungibility of any special budget allocations by the federal level, because of the present arrangement of subnational government financing, *i.e.*, a "safety net grant" could be too easily converted to a general revenue used for any purpose. The goal of the World Bank program in the social safety net area has been to establish two lending facilities to subnational governments with an overall funding of \$1.4 billion from the G7. The first facility aims at facilitating the transfer of services in the social area from enterprises to subnational government authorities in the next term and it specifically would exclude housing from the protected sector. The second facility aims at restructuring the provision of social services and income support programs in the longer term.

From a policy standpoint, it is unclear what ought to be done about the inequalities generated in the past because of the investment of enterprises in social services. There are now towns with relatively adequate housing, utilities, schools, and hospitals while there are other towns of the same size without even the most basic infrastructure and very deficient school and

health facilities. Moreover, it is clear that there are many territorial governments that cannot absorb the social expenditures offloaded by enterprises, because there is no tax base in the town other than failing and non-viable state enterprises. If one follows a criterion of maintaining present levels of service, the outcome would be to provide more services for those that always had more. To make informed decisions in this area is going to require the collection of much more information than is now available. Collecting and presenting this information in a useful manner, and studying the implications for the budget and interregional equity of different policies are all important areas of technical assistance.

The involvement of multiple institutions in social sector activities makes it difficult to assess how well certain budgetary objectives are being achieved and probably leads to duplication and waste. Local governments, the Social Support Fund and the Pension Fund are all involved. Coordination should become a priority for all agencies in the same policy area, and is probably a prerequisite for a successful technical assistance project.

EXPENDITURE ASSIGNMENT AND BUDGETING

The budget process in the Russian Federation is undergoing fundamental change. The budget is slowly being transformed from an accounting statement of public sector activities, formerly determined by Gosplan, to an instrument of economic policy for the central and subnational governments. Further improvement of the budget process will require structural changes and considerable training.

Budget Structure and Classification

The government of Russia is composed of three tiers. The Federal Government with the three traditional branches (executive, legislative, and judiciary); the "subjects of the federation:" the Republics, Territories, and Oblasts; and third, lower level governments (rayons, cities, and the smaller districts and settlements). There are two concepts of budget: the Republic Budget, which pertains to the fiscal activity of the Federal Government proper; and the Territorial Budget, which is the consolidated budget of all oblasts and their constituent local units. The territorial budgets represent 42 percent of the total consolidated government budget and this share has been slowly increasing in the past two years. In addition to the government budgets, there are extra-budgetary funds at both the central and subnational levels.

All budgets are presented with a functional rather than an economic breakdown. The three main budget heads at the federal level are "national economy," "social and cultural" and "defense." The two main items in the oblast and rayon budgets are "national economy" and "social and cultural." In addition to the recurrent budget, both levels of governments have capital budgets.

The classification being introduced with the 1993 budget represents an improvement on the changes introduced in 1992, and better fits international standards of classification, but the IMF and the World Bank have recommended further work on budget classification, and this could be made part of the scope of work of the USAID technical assistance project if desired by the government and the multi-laterals. On the revenue side it is necessary to identify external sources of finance such as bank credits and bonds. On the expenditure side, the "articles of expenditure" which identify programs should be transformed into a standard functional

classification. The "items of expenditure" classification will require most work, because at times it contains functions rather than types of expenditure and does not distinguish between interest and principal in the servicing of the debt.

Budget Preparation

Problems and Issues. At the federal level, the budget department of the Ministry of Finance is the coordinating institution charged with developing and presenting the budget to the Supreme Soviet. The Budget Department receives inputs and budget proposals from departments within the MOF in charge of monitoring line ministries and from other agencies. The budget proposals from the spending units and agencies make use of forms and tables designed by the Budget Department. The Ministry of Economy participates in the formulation of the capital investment budget and plays a major role in developing the economic forecasts necessary for budget development. The State Tax Service collaborates with the MOF in the making of revenue projections.

The budget prepared by the MOF is approved by the Council of Ministers and eventually by the President, who sends the draft of the Budget Law to the Supreme Soviet. The norm has been that the budget document does not reach the Supreme Soviet until one or two months before the start of the fiscal year. The entire budget cycle is started too late and it has been irregular and unpredictable. Both the executive and legislative branches of government have been happy to approve budgets for only the first quarter of the year and then wait to the second quarter or later to approve the budget for the rest of the year.

At the local level, one of the most critical steps in the decentralization process has been the autonomy and discretion gained by local governments in the formulation of their budgets. These rights have been granted in three pieces of legislation already in force in 1992, the "Law on the Rights of Local Self-Government" and the "Basic Principles of the Budget System and Budgetary Process" and more recently in 1993, the "Law on the Principles of Budgetary Rights and the Use of Extra-Budgetary Funds."

These laws provide for a strong principle of budget independence. Higher level governments (central government with respect to oblasts, and oblast governments with respect to their rayons) are, in principle, not allowed to interfere in the budget formulation process of lower levels of government, and mandates without adequate funding are not allowed. Breaking with a perverse budgetary practice of the past, these laws forbid the extraction of surplus funds by any higher level of government. However, true budgetary autonomy and independence for subnational governments does not yet exist, because of a combination of the absence of specific expenditure assignments and the continued use of "negotiated" tax sharing rates. The main point in this statement is easily illustrated. Subnational governments could end the fiscal year with operating surpluses, and the law clearly bars the Ministry of Finance from taking those surpluses. But, de facto, the Ministry of Finance can capture those surpluses by either reassigning additional expenditure responsibilities or "negotiating" a lower sharing rate in the VAT. In practice, central government mandates and upper level government involvement in the lower level government budget process has been routine.

Technical Assistance. There is a need to review and update the entire budget cycle. For this purpose a blue ribbon commission of Russian experts with representation from the executive and legislative branches could be appointed. The project would provide international expertise.

At the central government level, the MOF needs to develop the capability to formulate a macroeconomic framework for the preparation of the budget. This will require a capability to monitor the behavior of the economy and to develop macroeconomic targets that are compatible with overall economic policy objectives. In this respect, the IMF has recommended the reinforcement of the capabilities of the newly created Department of Macroeconomic Policy in the MOF. The Fiscal Analysis Unit being proposed in this project could also perform similar functions. The project should train staff in forecasting, the use of microsimulation models, and macroeconomic techniques.

Similar budgeting analytical capabilities should be developed in the Supreme Soviet. One way to achieve this is to build on the existing Budgetary Control Committee. This Commission already has put together a committee of 17 people, including oblast representatives, to move forward with a reform of the budget process. It would be necessary to review closely the work the Commission is supposed to have done already in the development of a fiscal information system. The Commission's staff should also be trained in forecasting, simulation, and econometric models.

There is a need to initiate a multi-year expenditure plan within the MOF. This will allow better integration of the public investment program and the annual recurrent budget. The analysis should include all the operations of extra-budgetary funds and all other quasi-fiscal operations.

Training in multi-period budgeting should also be made available to oblast finance departments, since the same need exists at this level.

In the area of budgetary standards and norms, the Ministry of Finance needs to plan ahead and develop a methodology for the computation of expenditure needs of local governments. These figures would be needed, for example, to implement the equalization pool discussed in the revenue assignment section of this report. Clearly, the Ministry should not try to go back to using the detailed expenditure norms that were used in the past. Instead, it is recommended to restart at once the study and elaboration of more aggregate expenditure norms which take into account the per capita features of local governments. These types of norms are also contemplated in draft legislation now being considered in the Supreme Soviet. The project should have a component on training on budgetary practices around the world on the use of indicators or norms in budget preparation. Specialized technical assistance will be also necessary in the appropriate use of budget "need" indicators.

Budget Execution

Federal Level: Problems and Issues. In 1992, a new system of budget execution was introduced, in which payments were linked to tax collections. One important reason for the change was that the Law on Budgetary Process prohibited the Central Bank from lending money to the MOF without an explicit authorization of the Supreme Soviet. Funds were allocated monthly rather than quarterly. The Law on Budgetary Process calls for expenditure reductions in the event of a shortfall in revenues and establishes a very specific cost cutting strategy.

All expenditure categories are to be cut proportionally every month, with the exception of several "protected" categories which include wages, medicines and transfers for social protection. Since 1992, sequestering has been used to force expenditures to match available revenues plus authorized borrowing by the Supreme Soviet. Budgeted expenditures represent a maximum amount to be spent and not an authorization to spend. The same exact principles apply to subnational governments. The difference between the two levels is that subnational governments have not (directly) borrowed any funds.

Russia's budget execution system apparently lacks an efficient control of expenditures. In most Western countries the execution of the budget is based on a three-stage procedure which facilitates ex-ante control of government expenditures. These three stages are: (i) the commitment of expenditures, meaning that budget appropriations are authorized, contracts are signed and procurement is initiated; (ii) the verification stage in which work is completed, bills received and the obligation to pay is verified by each spending unit; and (iii) the payment stage. In Russia control of expenditures is done at the payment stage rather than the commitment stage. This leads to difficulties in the control of expenditures, and to the accumulation of undesired arrears. Actually, financial control is exercised by limiting the amount of funds that the central government transfers to the oblast governments -- or the oblasts to the rayons. This means that there are no checks or information flows on spending until the payment obligation has been actually generated.

At the central government level, budget execution is the responsibility of the Budget Execution Department. This department executes the budget on the basis of the "smeta," which is a detailed statement received from the Budget Department with the accounts to which the

money has to be transferred, the line of transfer, and the purpose of transfer. The Budget Execution Department prepares the payment orders for the transfer of funds to the administrative agencies that, in turn, act as distributors of funds to other agencies. When the payment orders are sent to the Central Bank of Russia, the funds are transferred from the main Treasury account to the account of the respective administrative agency. All oblast governments are funded in the same way as central government agencies.

The changes in the process of budget execution and the financial management system over the past two years have been in part the reflection of changes in the banking system. Until recently, banks were required to make immediate transfers of government funds to the Treasury account at the Central Bank. Now they are required to do that only twice a month. There is, however, little supervision of banks at the local level and it seems plausible that some banks use the float to finance their operations. The most important cause of delays in transferring funds may have been the refusal of the Central Bank to perform the Treasury function of dividing enterprise tax payments between central, oblast and rayon governments. Instead, taxpayers (enterprises) have been asked to write three checks. The amount of paper work for local banks has increased significantly since large enterprises are required to make three estimated tax payments every month, and medium size enterprises are required to make one payment every month. Because of the delay in the approval of the budget, and the shortfall in liquidity due to the mismatch between revenue inflows and expenditure commitments, the central bank extended several forms of credit to the government during 1992. In 1993, all credits must be authorized by the Supreme Soviet.

In response to these problems the MOF has created the Treasury as a new department within the Ministry. The decision to set up a Treasury Department within the MOF was based on the existence of several important weaknesses in the process of budget execution. In particular, the MOF lacks a mechanism for the control and monitoring of spending before the payment stage. The Central Bank of Russia monthly reports only reflect cash movements in the accounts of ministries and other agencies and contains no information on expenditure commitments and the delivery of goods and services. In addition, what appears to be a sizable share of expenditures by central government agencies and subnational governments remain outside the regular information flows of the MOF due to the existence of extra-budgetary funds. Another important problem in budget execution has been the delay, and difficulties with proper crediting of tax collections by participating banks, and the proper allocation of tax sharing funds among the different levels of government.

The proposed Treasury Department within the MOF will have the responsibility for the financial management of all central government financial operations. The goal is to set up a computerized system for the execution of all budgetary and extra-budgetary transactions of the federal government. This system will automatically generate the reporting of revenues received and accrued expenditures. The Treasury Department will require from all spending units to register all their operations from the commitment to the payment stage. After verification of budget allocation and compliance with any cash limits, the Treasury will issue payment order against a unified account with the Central Bank. This mechanism allows the government to set up effective spending limits.

Besides its fundamental role in budget execution, the proposed Treasury will also produce forecasts of revenues and spending needs.

The broad framework of the Treasury has been already designed with the technical assistance of the IMF. The implementation work will still require the training of personnel in accounting and standard Treasury procedures. The implementation will also require the design of software which matches the need accounting system. The IMF has recommended setting up special task units within the new Treasury to implement separate pieces of the work.

Oblast Level: Problems and Issues. Budget execution at the oblast and rayon level presents similar problems to those at the federal government level. Banks are not involved in the execution of the budget or in cash management for the oblast. Enterprises write three different tax payment checks (one for each level of government). With the growing number of enterprises, it has become more difficult to keep track of the accuracy of the payment orders. Enterprises frequently make one single payment to the Federal government and then the oblast has to recover its money from the MOF with significant delays.

The Accounting Department is in charge of the execution of the budget of the oblast. This departments work together for the planning of revenues and spending need, of the Budget Department, and with the banks, for tracking revenues and actual expenditures. Each of the items in the budget are coded and entered into computerized files as the budget is executed. In the Moscow Oblast, the accounting department receives all "payment orders" from the bank for the taxes paid by enterprises. After the documents are coded and input, the payment orders are transferred to the state tax office together with a computer statement of the charges registered

during the day. The State Tax Office is supposed to verify these for accuracy. The accounting department also keeps an up-to-day account for revenues and expenditures of the oblast government, the rayons, and the consolidated budget for the entire oblast.

Expenditures are authorized by the budget department, and the accounting department makes the actual transfer of funds at the bank for the spending unit. The payment order is against the main oblast account at the bank. In turn, each spending unit has its own account at the bank. The transfer of funds is done on a monthly basis. Once the spending unit has been credited the funds, it can write checks up to the maximum authorized in the budget. On the 30th of the month, each spending unit is required to submit a report to the accounting department verifying the use of the funds.

The spending units consist of the main departments and committees (about 35 to 40 in number). Each of these spending units funds an account for a number of smaller spending units, such as schools and hospitals.

The budget is executed on a monthly basis, and at the end of the month the oblast supposedly knows to the last kopeck how much has been received and how much has been spent. A formal statement of the executed budget is available on the 15th of the next month. The monthly statement also includes the revenues and expenditures of all rayons in the oblast. The accounting office of the oblast checks the balances of rayons at all banks to verify the accuracy of the data provided. However, the oblast accounting office has no information on the extra-budgetary funds of rayons or even of the oblast soviet.

Technical Assistance. At the federal level, the most urgent unanswered need for assistance is for training and support for the start up of the new Treasury as a department of the MOF.

At the oblast level, there is also a need for a treasury department with functions similar to those assigned at the federal level treasury. This function was performed before by the central bank for all oblast governments. The Moscow Oblast is actually hoping to contract with the new Federal treasury to carry out the treasury function of the oblast government.

Other areas of budget execution, payment arrears and sequestering, require close monitoring. Some subnational governments appear to be using arrears as a source of regular financing. The size of the arrears would have been more apparent if subnational governments used an accrual accounting basis. However, the law allows local governments to use a cash accounting basis, which helps them to hide a portion of their budget deficits by simply not making timely payment of their bills. The federal government also has been consistently in arrears with subnational governments -- there is an average delay of two months in the flow of funds. From a practical viewpoint, the practice of carrying arrears only offers governments temporary relief, since prices charged by suppliers are quickly adjusted upward to compensate for the additional costs of delayed payment. More often than not, total costs for local governments will be higher since all suppliers adjust their prices upward.

Some subnational governments operate on a very conservative basis in the execution of the budget with some sort of sequestering in place, *i.e.*, authorizations for disbursement in excess of revenue collections are not allowed. Although responsible budget practices are laudable, especially under the present macroeconomic circumstances, perverse consequences of sequestering need to be avoided. In particular, without a detailed plan from the local soviet on priorities for

all items in setting the local budget, sequestering empowers the local finance officer to rewrite or redirect budget priorities. The room for distortion is larger, the smaller the budget that is eventually executed.

Technical assistance is required to carefully study and submit alternatives to several parts of recently approved laws which unduly tighten the degree of central control over subnational budgets. For example, if a rayon is expected to have a deficit (revenue collections fall short of planned expenditures) or if the deficit ceiling is reached during the budget execution, the "Law on Basic Principles of the System Budget" establishes the specific mechanism by which local governments should attempt to balance their budgets. The law requires that current expenditures take priority over capital expenditures. If a deficit remains after striking all capital spending, the local government must then take monthly pro rata reductions of current expenditures (by 5, 10, 15 percent or as needed) across the entire budget. The only exception would be for "protected" items. This approach to deficit reduction is *de facto* in some countries, though this may not be explicitly stated in the laws. However, this shared experience with other countries does not make it any more right or attractive.

This type of restriction in Russian laws limits the expenditure discretion that local governments need to increase their efficiency in the delivery of public services. In some localities an ex-ante deficit may be best eliminated by cutbacks in current expenditures, or across-the-board cuts may not be warranted. Only the locality can judge this best, in line with the preferences of its inhabitants. In general, these restrictions should be eliminated. In particular, the requirement that capital expenditures be sacrificed first is not appropriate. The local

government is in the best position to decide what should be "protected," and the ability of higher levels to impose mandates is inappropriate unless the service is characterized by external effects.

Evaluation and Audit

Problems and Issues. Evaluation and ex-post audit of the budget execution in Russia are perhaps the weakest links in the budget process. Neither the federal nor the oblast governments perform a thorough review and assessment of budget outcomes; *i.e.*, the review of budget programs and their results. Yet ex-post evaluation is most helpful as a feedback to policy makers on how well their objectives are being attained through the implementation of the budget.

Audits in the past were conducted by the finance department of the next highest level of government, and for the central government, by the Department of Auditing of the Ministry of Finance. This latter has a staff of only 70, so it is improbable that effective ex-post audits for budget execution have been conducted. The audit function should be performed by an independent body. To this effect, the Supreme Soviet has recently created an audit organization which would directly and exclusively respond to the Supreme Soviet. However, this organization does not appear to have started operations.

At the oblast level, very little auditing takes place. Two years ago a plan was developed to audit all rayons and cities once every two years. This audit would be done by oblast officers. In turn, federal auditors would audit the oblast government every three years. This plan has not been implemented.

At the subnational level, auditing of public accounts seems to take place only when the local soviet or some other body raises questions on the use of funds. In any case, the audit

agency is not independent but actually part of the regular administration. This creates a conflict of interest. Audits of state enterprises seem to have been a bit more frequent. In the case of the Moscow Oblast, the last audit was in 1989. Before 1989, the oblast was audited every year.

With respect to audit, the best strategy at the federal level is to support this function with training and technical assistance, directed at the independent audit unit recently created by the Supreme Soviet. The audit function at the subnational level is also an area for potential technical assistance. Oblasts and rayons need to develop separate independent budget audit units. Technical assistance could be offered in the design of such units and the training in accounting and auditing techniques of their personnel.

The Accounting System

Problems and Issues. The present system of accounting is the "centralized accounting systems" inherited from the previous regime. In this structure many independent spending units (e.g., hospitals or schools) do not carry their own accounts. Instead, these accounts are kept by a centralized accounting department in the ministry or higher level agency. These centralized accounting units are quite independent and are supervised by executive committees which in turn operate under instructions and methodologies prepared by the MOF. The regional accounting officers are employees of the MOF. These regional accounting units often coincide with the oblasts jurisdiction and are responsible for overseeing the execution of the oblast budgets. The territorial accounting units are represented by the financial departments of this level of government.

The charts of accounts are standard throughout the national territory, with one main revenue account and one main expenditure account. Each of the major ministries has an account which is numbered sequentially and several subaccounts for the main expenditure categories. Many budgetary units also maintain "special means accounts" which are considered extra-budgetary. Spending on all accounts is limited to the allocated amount and no funds can be shifted across accounts by the spending units. The shifting of funds by ministries and agencies within the subaccounts is allowed. To avoid the shifting of funds allocated to wages, separate payment orders are issued.

The MOF relied heavily on the banking system for these accounting services until 1992, when the Central Bank refused to continue this support. The dissolution and fragmentation of the old banking system has also made it more difficult to maintain proper accounting of public sector transactions.

Russia's budgetary accounting differs from generally accepted international accounting practices such as those delineated in the IMF's *Government Finance Statistics Handbook*. In Russia's public sector accounting, for example, borrowed funds are considered a "revenue," and repayments of the principal borrowed are considered part of "budgetary expenditures;" in the IMF *Handbook* methodology, both transactions are considered "below the line" financing items. In practice, reserves from previous years are often included as revenues in the budget for the present year, even though the law explicitly states that there should be an unchanged reserve fund at the end of each fiscal year.

Because accounting is done on a cash basis, it is not always clear what the actual deficit may be. Rather than limiting the amount of funds for actual payments (a legacy of procedures

from the planning era) it would preferable to introduce controls at the commitment stage and switch the accounting system to an accrual basis. This eventually will require the introduction of formal contracting and procurement procedures.

At present, contracting and purchasing are most often carried out on an informal basis. In the previous regime the plan determined the source and type of supplies. For the last two years many local governments have relied on personal contacts and barter arrangements for procurement. At present, open bidding and contracting procedures do not exist. The accounting system also should be transformed from a cash to an accrual basis.

Technical Assistance. Practically all aspects of budgeting accounting and fiscal management are in need of reform and upgrading both in design and in training of personnel. Educational institutions in Russia are not prepared to offer training in these areas because of the lack of curricula and instructors trained in these areas. The project could play a key role in this area.

Budget Reporting and Information

Problems and Issues. All spending units, including oblast governments, report monthly to the MOF on the use of their funds. These reports show the flows in and out of the main Treasury account, *i.e.*, those funds credited and debited to the account of the spending unit. The Division of Accounting of the MOF verifies the accuracy of these transactions against bank records, meets with representatives of the spending unit as required, and prepares a monthly and

an annual budget execution report. The quality and accuracy of the reporting needs to be improved.

The MOF receives budgetary information from several sources:

- the banking system (the Central Bank of Russia) reports monthly on the cumulative revenues received by the government. This is done with a two week delay, and it can be subject to sizable revisions. The Central Bank also reports the outstanding balances of the main spending units. However, these balances do not necessarily reflect the actual expenditure commitments of the spending units. Only cash transactions get reported and this latter information is only available after three weeks.
- Each ministry presents an monthly aggregate report showing the budget by section, actual disbursements and existing balances. However, coverage of all spending units is not complete, and the information is often received late. The more detailed quarterly reports from the ministries are received with a delay of 35 days.
- Oblasts report directly to the MOF about their monthly budget operations, but with a delay of 3 weeks. Since no banking data are presented for local governments there is no way for the Budget Execution Department of the MOF to verify the accuracy and completeness of the consolidated information presented by the oblasts. The oblast reports include borrowing from the MOF, but there is no reporting on loans from the banking system.
- The State Tax Service provides only tax information since the basis for its information is a copy of the payment order issued by taxpayers against their bank accounts. In addition, some revenue items such as custom taxes and VAT on imports are reported by the Customs Commission. All levels of government submit monthly, quarterly and annual reports. To get data on a timely basis the MOF plans to use satellite communication; but with the time zone differences and poor conditions of phone lines, communication is a difficult problem.

Capital Budgeting

Changing Investment Responsibilities. The assignment of public investment responsibilities among the different levels of government of the Russian Federation -- central, oblast level and rayon level -- is going through a period of transition. These changes have

implied significant modifications in the budget preparation and execution of all three levels of government. Public investment can be fairly typified as the most confusing and unsettled area in the public expenditure arena.

Two main factors have contributed to this state of confusion. The assignment of capital expenditure responsibilities has gone from being a purely central government responsibility in the previous regime to being a predominantly local and regional responsibility at the present time. This radical shift is probably less the result of careful design than it is the result of budgetary pressures at the federal government level. However, the recent changes could result in an improvement in the allocation of resources within the public sector, primarily because it will bring investment discussions closer to the local population.

The other main source of confusion is the multiple sources of public investment finance and the difficulty of accounting for all of them in a system of intergovernmental relations with interdependent budgets. The sources of public investment financing include not only the federal, oblast and rayon budgets but also special programs and transfers engineered by presidential decree or initiatives of the Supreme Soviet which are not always reflected in the budget; extra-budgetary funds often in unknown amounts; and public enterprises from their own surplus funds or from federal funds. Although oblast and rayons are in principle allowed to borrow for capital investment purposes, thus far there has been no substantial bank borrowing and no public debt issuing by subnational governments. This multiplicity of funding sources for public investments has meant that there is no reliable information on the level of funds invested in each subnational jurisdiction.

Under severe budgetary pressure the federal government in mid-1992 shifted many types of responsibilities for capital investment to local governments. This shift in responsibilities unfortunately included not only the type of infrastructure that can be properly considered the responsibility of local governments, such as schools and hospitals, but also capital investments in areas that are clearly of national significance and should not become the responsibility of local governments (such as airports, inter-oblast highways, and housing for military personnel).

The drastic reassignment of investment responsibilities were announced in July 1992 as permanent. However, some of these expenditure responsibilities now have been shifted back to the federal government. Field visits reveal that the impact of this decision on local governments may not have been too significant for certain items because little investment had taken place.

Although there is still confusion about what level of government is responsible for what type of public investments, the overall picture of capital expenditures responsibilities in 1992 is very different from what it was in 1990-91.

In the "social sphere," almost 100 percent of investments in the social sector are now the responsibility of subnational governments. In the "economic sphere" there were also significant shifts in responsibilities in 1992. The most important sectors shifted down to the local sector were agriculture and agro-industries. Until 1992 all investments in the agricultural sector were a federal government responsibility. In substance these capital investment are free subsidies to the agro-industrial sector. The importance of agriculture in capital expenditures at the oblast levels is illustrated by the expenditure figures for the Moscow Oblast (an industrial oblast). In 1992, investment in agricultural projects by the oblast represented 18 percent of all its capital expenditures. In 1993 this figure will rise to 56 percent of all investments in the Moscow oblast.

The other important capital projects in the economic sphere are equipment and infrastructure for public utilities. Before 1992, all investments of public utilities were financed by the federal government.

The Role of Local Governments in Public Utilities. Public utilities in Russia include not only what is understood for that term in Western countries -- gas, electricity, water and sewage - - but also communal services such as garbage collection and cleaning, and most notably housing services. Subsidies for housing services are by far the most onerous burden on rayon budgets. Public utilities are owned by oblast and rayon governments but quasi-independently operated. The funds for capital investments since 1992 come from the oblast budget and sometimes, depending on the service, there are contributions from the rayon budgets. Some utilities also have used surplus funds to contribute to the financing of capital investments. Before 1992 all funds for public utility construction came from the central government. Although public utilities do have the ability to borrow long term for investment purposes, none seems to be doing so.

There is a 100 percent subsidy to public utilities for equipment and structures. Public utilities do not have to return any funds to the government budget to repay the cost of facilities and neither is the structure of service tariffs set up to recover any of the capital costs. The operating subsidy from the budget to public utilities consists of covering the difference between the costs of operation and the actual price charged to consumers. Most of the fees and service tariffs are set by the federal government at levels well below operating cost recovery. The federal government sets rates for water supply, sewage, heating, electricity, gas, and garbage collection. Most of the time these restrictions apply to services provided to households. Public utilities have

more freedom in their dealings with enterprises. One price not controlled by the center is transportation, but popular pressure has forced local governments to also keep these prices very low.

The federal government does not provide any direct subsidy to local governments despite the direct expenditure mandates implied by the controlled tariff structure for the services provided by public utilities. However, subnational governments are in principle compensated for these "mandated" subsidies because these costs are taken into account in the budget negotiation with the MOF, in order to establish the sharing rates of the major taxes and the overall budget subsidy to the oblast. Likewise the budget of rayons are adjusted by oblast governments to take into account their obligations toward public utilities.

Current Issues in Capital Budgeting. The Law on the Basic Principles of the Budget System and the Budgetary Process establishes the separation between the recurrent and capital (or development) budgets for jurisdictions at all levels of government. These two budgets are to be voted and approved separately from each other by the soviet of the respective jurisdiction. This has meant, for example, that since 1992 all rayons have had a capital budget.

At the federal level, the division of responsibilities for capital budgeting is still shared by the MOF and the MOE. The division of power between the two ministries has been shifting back and forth over the past year and it has not been settled yet. At present, both ministries help implement the government investment program for the economy. Budgetary limits for investment spending and ultimately investment priorities are set by the Council of Ministers and enforced by the MOF.

The role of the MOE has been reduced to maintaining a list of approved projects which previously have been reviewed by line ministries (*e.g.*, request for school buildings are reviewed by the Ministry of Education). The MOE appears to do very little in terms of planning and capital project evaluation and selection and it clearly has nothing to do with financing. Some additional roles for the MOE at the present time consist in the development of expenditure norms for budget preparation and the tracking of data.

In 1992, there were many cases in which oblasts diverted funds for capital investment in a particular sector -- as agreed in budget negotiations with the MOF -- to capital investments in other sectors or even for recurrent expenditures. There is draft legislation in the Supreme Soviet that would prohibit this kind of intra-budget shifts to oblasts. But this legislation would seem to clash with the budgetary autonomy given to subnational governments in several pieces of legislation recently enacted.

The selection of capital projects and the formulation of capital budgets at the oblast follows a pattern similar to that at the central government level. For example, the Moscow Oblast for 1993 has a list of projects for each rayon and for the oblast itself which had been put together by the oblast Committee on Economy. Each project has attached to it a list of possible sources of finance. Sometimes rayon governments and less frequently enterprises participate in the financing of projects.

After the list of projects is finalized, the Committee on Economy works together with the oblast department of finance to agree on what projects should be financed within the overall limit provided by the budget. The finance department makes the decision on the final list of projects

to submit to the oblast soviet for review and approval for next year. In the case of the Moscow oblast these recommendations were approved in 1993 without any major changes.

Technical Assistance

The project could offer the Russian Government technical assistance on capital budgeting issues. At present, there is still considerable confusion on the assignment of capital expenditure responsibilities, and the assignment continues to be in a state of flux. A clear assignment of responsibilities should be developed.

More concretely, the technical assistance in this area would center on the three following issues:

- The federal government should develop a Public Investment Program of viable projects. The list of projects should include those unfinished projects that should be continued, and which should be ranked with all new projects. Oblast and rayon governments should be encouraged to do the same in their respective jurisdictions. The appraisal of these projects needs to be based on a rigorous cost-benefit analysis using realistic rates of discount. The appraisal techniques that were better suited to the material product system should now be discontinued. There is a need for training of budget officials at all government levels in modern project evaluation techniques.
- There is a need to bring extra-budgetary funds into full reporting of government expenditures. It would be even better, albeit harder, to eliminate most extra-budgetary funds.
- There exist two initiatives at present to develop non-budgetary financing for local government projects. First, a new State Financing Company has been created at the federal level with the charge of providing long term credit to subnational jurisdictions for selected capital investment projects. The second initiative has not been approved yet. The Draft Law on Subventions to Local Governments -- which has been under review for over a year -- envisages the formation of an extra-budgetary fund to finance capital projects based on selection criteria different from the regular budget. The most preferred alternative is the development of financial intermediaries and capital markets to allow local governments to issue bonds with the appropriate maturity to finance long term capital investments. Unfortunately

these institutions will develop only in the longer run as the Russian economy stabilizes and matures as a market economy. The constitution of specialized lending institutions for local governments at the federal level may be the only desirable way to proceed at the present time. This financial institution or institutions should use the most strict modern banking criteria in their lending. Their operations should not be seen as the proper vehicle to subsidize desirable activities at the local level or support poorer oblasts. All these policies should be implemented through budgetary channels.

IV. ENTERPRISE EXPENDITURES ON SOCIAL SERVICES AND THE PRIVATIZATION PROCESS

INTRODUCTION

During the period of communist rule in the former Soviet Union, many large state enterprises performed a dual role in the Russian economy: they produced goods and services for sale to customers, and they provided a range of social services to their employees and to others in their communities. These social services included child care (kindergartens),¹ sports and cultural facilities, clinics, cafeterias, and, importantly, housing, and were referred to in their entirety as "social sphere objects" (SSO). In some respects, then, enterprises were an extension of government in that they were assigned responsibility for helping to provide many of the services that normally would be provided by governments in western countries. Under the new Russian Federation, most of these enterprises are to be privately owned, and the recent spate of laws and decrees on privatization have ruled that the responsibility for these SSO, and attendant assets, must be transferred to subnational governments. Thus, the government sector, and particularly subnational governments, are being asked to absorb a potentially significant increase in service responsibility. The Vice Governor of the Moscow Oblast made a particularly dramatic statement in this regard, that the absorption of these responsibilities from enterprises would increase oblast government expenditures by 50 percent.

This reassignment of expenditure responsibility raises three important issues. First, there is a concern that the privatization process will be slowed down because local governments will

¹Child care, day care and kindergartens in Russia all refer to the same thing.

be reluctant, or unable, to assume the financial and administrative responsibilities implied. The analytic work on privatization -- particularly that research and technical advice carried on by the external donors -- is largely silent on this issue. Second, there is a concern that local governments will be unable to finance the SSO at adequate levels. Third, there is the broader issue of the proper role of enterprises and of local governments in the provision of social services.

The policy importance of these questions in Russia depends in large part on the magnitude and the composition of enterprise expenditures on the SSO. Are enterprise expenditures on SSO significant, are they marginal, or are they largely limited to housing? Unfortunately, there is a paucity of information available to answer these questions. The main purpose of this section is to provide some estimates of enterprise expenditures on SSO. The results reported here are based on interviews with enterprise managers and government officials, conducted in Russia during the period May 24 to June 4, 1993. The interviews were conducted with 13 enterprises located in the Chelyabinsk and Moscow Oblasts, and with government officials in the corresponding oblast and local governments. This information represents some of the first available on the extent and type of enterprise provision of social services, and it should provide some useful, if initial, insights. However, these estimates should be used with caution. The survey of enterprises was not a random one, and there is the distinct possibility that the enterprises or the oblasts surveyed are not representative. Moreover, it is a very small sample.

This report describes the implications of the disposition of the SSO, identifies the major issues surrounding the treatment of the SSO during the current privatization process, and provides estimates of the relative importance of these social expenditures both to the enterprise and to the

local government. The report then makes a set of general recommendations about the technical assistance that might be provided.

PRIVATIZATION IN RUSSIA

The basic goal of privatization is to transfer assets and responsibility for enterprise decisions from the state to the private sector. The hope is that this transfer will lead to a radical restructuring of incentives, which in turn will lead to greater efficiency in operations and more responsiveness to market pressures.

The legislation on privatization specifies a precise schedule. However, this schedule is not always maintained in practice. The length of time that it takes to complete the privatization process depends largely upon the size of the enterprise. Smaller enterprises may complete the process in as little as 1 month, although 3 to 6 months is more common. For larger enterprises one year is the usual length of time, and for some enterprises the process may take up to three years.

All of the individuals interviewed said that the time required for the privatization process was lengthened if an enterprise provided SSO. The additional time is needed in order to work out an agreement between the enterprise and municipality over the transfer and the maintenance of the social objects (see below). Specifically, delays are due to difficulties in coordinating the transfer of the SSO from the firm to the municipality (*e.g.*, will the enterprise transfer equipment needed for maintenance along with the SSO?), in finding jobs for those individuals who have worked in the enterprise to provide the SSO (*e.g.*, will these individuals be employed by the city or be transferred to other jobs within the enterprise?), and, more broadly, in negotiating the

details of the transfer with the enterprise (*e.g.*, which social services will be transferred to the municipality and which will be kept by the enterprise?). However, many of the individuals interviewed said that most enterprises do not provide any SSO, so that the privatization of these enterprises has not been affected by the SSO issue. Further, they stated that even among enterprises that provide SSO, the total number of firms that has been privatized has not been affected by the SSO.

The privatization plan also specifies the period of time over which the purchase of shares will occur. It can be up to 3 years, but it is usually set at 6 months because of inflation and worker turnover. The time it takes for the government to sell the shares is more variable, although a recent Presidential decree has shortened the time the property fund can take to sell shares of an enterprise.

The initial privatization decree required that all SSO be transferred from the enterprise to the municipality, including all assets associated with the SSO. However, discussions with enterprises and municipalities indicate that (with some limited exceptions) this transfer has not taken place. Several reasons are given. First, there is widespread concern that the municipal governments would have difficulties financing the social services. Second, enterprise managers fear that the anticipated failure of local governments in maintaining the SSO would have a severe impact on their workers and, more broadly, on the community in which their enterprise is located. In short, it is widely recognized by government officials and enterprise managers that the transfer of the SSO to municipalities could impose a significant financial burden on municipalities, one that could endanger provision of the social services. Nevertheless, there is some agreement

among government officials that the SSO are the proper function of government, not enterprises, and that eventually these services should be provided by government.

Instead of an immediate transfer of the SSO, the municipal property committees have negotiated with enterprises, both in the short and the long term transition arrangements. Enterprises generally wish to keep their more profitable SSO, and transfer their unprofitable ones to the municipality; local governments clearly have the opposite preferences. According to government officials, these negotiations have slowed the pace of privatization, at least for those enterprises that now provide SSO, in part because there are no widely used guidelines for the treatment of the SSO. Some municipalities have attempted to specify guidelines for which SSO can be privatized. For example, officials of the Moscow Oblast indicated that housing, kindergartens, and schools will not be privatized (or purchased by the enterprise), while rest centers, summer camps, clinics, and the like can be purchased by the enterprise if these facilities cater primarily to workers of the enterprise. Further, for those SSO that cannot be privatized, either the oblast will require that the relevant facilities be turned over to the municipality, or the municipality will manage the facilities but the federal government will own and finance the services. Again, however, it is not known if such guidelines are widely implemented at present, and, because each oblast has the authority to introduce its own guidelines, other oblasts may well be following a different approach. For example, some property committee officials indicated that they were considering joint municipality-enterprise finance of the SSO.

In practice, then, most privatized (or privatizing) enterprises reach some agreement with the property committee on the SSO that will remain the responsibility of the enterprise and those that will be transferred to the municipality. These lists are specified in the privatization decree.

Some officials estimated that 90 percent of all enterprises that had gone through privatization had signed such agreements. It does not appear that these conditions are legally enforceable upon the enterprise. Some enterprises can and have rejected the conditions, an action that has contributed to some delay in the privatization program and has led municipalities to request additional funds from their oblasts.

Although these conditions vary by enterprise, discussions suggest that the general strategy taken by the property committee is twofold: require that the enterprise continue to provide most of the SSO for a period of time (up to three years), and promise that the municipality will take over most of the SSO (especially housing) at the end of that time. In effect, the municipalities seem to be adopting a short-term, twofold strategy: (a) get the enterprise to provide the SSO for the immediate future while the financial condition of the municipality is precarious and that of the enterprise is more secure, and (b) assume that the financial condition of the city will improve by the time that it must take over the provision and the finance of the SSO.

A variety of additional considerations that may inhibit the transfer of SSO must be addressed in the negotiations between the property committee and the enterprise, and these are best illustrated by example. In many cases the heating and water systems that serve the housing units of an enterprise are centralized, so that if the company closes down the boiler, the apartments will not be served. Also, the utility systems of the enterprise and the municipality may be incompatible. In one municipality the pipes that serve the different housing units of the enterprise and the city have been laid at different depths, and the municipality does not have the equipment needed to interconnect the systems. A similar issue concerns the maintenance of the housing stock. A particular enterprise wanted to get rid of its housing stock but wanted to keep

the equipment (e.g, welding equipment, pumps, compressors) that is required to maintain the housing. In some cases the enterprise has operated a sports facility or clinic that became part of the enterprise's capital, and the city wanted to take it over and make it available to the entire population of the municipality. This illustrates the wide range of issues that must be addressed in the negotiations between the property committee and the enterprise.

Absent in this process is a clear distinction between those social services that are properly a function of government and those that are increments to employee compensation, and therefore, properly financed and delivered by the enterprise. It is time to move toward a more formal definition of the appropriate role of enterprises and of subnational governments in the provision of social services.

A crucial question surrounding the SSO issue is their magnitude and composition, but little information is currently available. Short of this information, it would be difficult to plan for the assumption of SSO by local governments. The next section presents some preliminary estimates on enterprise provision of the SSO.

ENTERPRISE EXPENDITURES ON SSO: CASE STUDIES

This section reports on some illustrative estimates of the magnitude and composition of enterprise expenditures on SSO. The results clearly indicate that enterprise expenditures on social services are important, judging from the information obtained from enterprises and from the municipalities in which the enterprises are located. At least for this sample, housing dominates enterprise social service programs.

Case Studies of Enterprises

Balance sheets, income statements, and other detailed information concerning enterprise expenditures on social service expenditures were obtained in the course of intensive interviews with eleven enterprises in Chelyabinsk and Moscow Oblasts. Confidentiality was promised, and thus the names of the enterprises are not revealed. Exhibit 1 contains a list of all of the SSO that one or more of the enterprises provide. All but one enterprise interviewed provided some form of housing to their employees. Enterprise provision of other types of SSO is quite varied, and not all types of SSO listed in Exhibit 1 are provided by every enterprise. It is important to remember that only larger enterprises tend to provide any of the SSO; most smaller enterprises in Russia make little or no expenditures on the SSO.

An analysis of the relative magnitude of the SSO expenditures in 1992 is presented in Table 1. For each of the eleven enterprises, selected data on the assets, revenues, and profits are presented along with the gross and net expenditures on social services. The first thing to note from Table 1 is the substantial differences in enterprise sizes. For example, total revenue ranges from a low of R 382 million (Firm I) to a high of R 64,570 million (Firm A), and total assets vary from R 413 million to R 81,553 million. We do not have a size distribution of the population of Russian enterprises, and thus, cannot make any definitive statements concerning the representativeness of this sample. However, because some of these enterprises are oblast-level firms and because all of these enterprises provide some form of social services, it would seem that the sample is biased toward larger enterprises.

EXHIBIT 1

ENTERPRISE PROVISION OF SSO

Housing
Water system
Heating system
Electrical system
Roads
Sewer system
Day care
Clinics
Hospitals
Movie theaters
Concert halls
Summer camps
Sanitoriums
Hockey stadiums
Swimming pools
Sports camps
Resorts
Hotels
Cable TV centers
Canteens/Cafeterias
Food processing
Food supplies
Agricultural plots
Social clubs
Pensions
Technical schools

TABLE 1
ENTERPRISE EXPENDITURES ON SSO
AND ENTERPRISE ECONOMIC PERFORMANCE, 1992
(in thousands of rubles)

<u>Item</u>	<u>Firm A</u>	<u>Firm B</u>	<u>Firm C</u>	<u>Firm D</u>	<u>Firm E</u>
Fixed Assets	21,523,992	706,578	12,217,740	1,442,000 ^a	799,299
Total Assets	81,553,182	1,208,293	29,710,742	NA	3,423,071
Total Revenues	64,570,440	1,127,459	19,078,821	NA	6,702,554
Gross Profits	27,045,152	237,562	3,927,044	2,199,918	2,237,805
Net Profits	18,071,570	158,109	2,742,160	1,037,613	1,514,827
Gross Expenditures on Social Services	474,643	23,034	530,428	393,350	101,255
Net Expenditures on Social Services	391,389	20,937	373,518	NA	95,470
Gross Expenditures on Social Services as a Share of:					
Total Revenues	0.74	2.04	2.78	NA	1.51
Gross Profits	1.76	9.70	13.51	17.88	4.52
Net Profits	2.63	14.57	19.34	37.91	6.68
Net Expenditures on Social Services as a Share of:					
Total Revenues	0.61	1.86	1.96	NA	1.42
Gross Profits	1.45	8.81	9.51	NA	4.27
Net Profits	2.16	13.24	13.02	NA	6.30
Net Expenditures on Social Services per Employee	11.18	17.45	NA	7.42 ^b	19.89
Book Value of Social Services Assets as Share of Total Assets	3.26	4.07	6.21	NA	2.53

TABLE 3 (continued)

<u>Item</u>	<u>Firm F</u>	<u>Firm G</u>	<u>Firm H</u>	<u>Firm I</u>	<u>Firm J</u>	<u>Firm K</u>
Fixed Assets	192,920	495,847	1,128,340	244,392	645,872	150,360
Total Assets	531,413	1,049,510	2,784,445	412,763	1,137,141	548,737
Total Revenues	623,241	2,988,804	1,044,019	382,129	1,089,695	542,011
Gross Profits	119,785	1,163,399	354,230	103,272	180,571	259,655
Net Profits	76,370	816,469	236,099	61,964	84,206	172,012
Gross Expenditures on Social Services	16,400	162,362	40,879	NA	68,059	NA
Net Expenditures on Social Services	NA	102,979	30,251	472	63,160	19,836
Gross Expenditures on Social Services as a Share of:						
Total Revenues	2.63	5.43	3.92	NA	6.25	NA
Gross Profits	13.69	13.96	11.54	NA	37.77	NA
Net Profits	21.47	19.89	17.31	NA	80.82	NA
Net Expenditures on Social Services as a Share of:						
Total Revenues	NA	3.44	2.90	0.12	5.80	3.66
Gross Profits	NA	8.85	8.54	0.45	34.98	7.64
Net Profits	NA	12.61	12.81	0.76	75.01	11.53
Net Expenditures on Social Services per Employee	20.50	31.53	5.11	1.21 ^b	21.05	33.62
Book Value of Social Services Assets as a Share of Total Assets	NA	3.05	NA	NA	2.46	0.84

SOURCE: Information provided by enterprises.

NA = Not Available

TABLE 3 (continued)

^a Main assets, not fixed assets, are used.

^b These are gross expenditures per employee; not net expenditures.

Some enterprises receive revenues from user charges for the provision of services. These revenues are derived mainly from the provision of utilities to the occupants of housing. The magnitude of these revenues is shown by the difference between the gross and the net cost of the SSO expenditures. In general, the magnitudes are not large. On average, for the seven firms for which we have both gross and net expenditures, these revenues account for less than 24 percent of the gross expenditures.

There is enormous variation in the net expenditures on the SSO. Net expenditures as a share of net profit range from less than 1 percent to over 75 percent. The lowest percent is for Firm I, because it was able to dispose of most of its SSO several years ago, and now operates only day care facilities. The largest percent is for Firm J. The high percent for this enterprise is due mainly to a very low profit margin on sales; expenditures as a percent of revenues are high, but are closer to the average of all firms. For most other firms in the survey, net SSO expenditures as a percent of net profit average about ten percent.

Expenditures on social services per employee vary widely, from R 1.21 thousand to R 33.62 thousand. Generally, the per employee expenditure is smaller in larger enterprises.

The average net expenditures on the SSO for the eleven firms in 1992 was R 126.6 million.² It is reported that there are 20,000 to 27,000 industrial enterprises in the Russian Federation (Hughes and Butler 1993).³ Assuming the sample average applies to all industrial enterprises, this estimate suggests that in 1992 total SSO expenditures by all enterprises was

²Note that information on net expenditures is not available for all enterprises. For those firms for which net expenditures are not available, the average of the ratio of net to gross for the firms reporting both is used.

³Hughes and Butler (1993) rely on the 1990 Russian Statistical Yearbook. They note that the number of industrial enterprises is reported as 26,900 in one place and 20,553 in another.

between 2.5 trillion and 3.5 trillion rubles. At the beginning of 1993, the Ministry of Finance estimated the total amount of tax deductible SSO expenditures by all Russian enterprises at R 1 trillion for 1993 (not accounting for inflation). Actual expenditures on the SSO are significantly greater than deductible expenditures.

If the SSO expenditures are considered a tax on gross profits, then seven of eleven firms would be paying a profits tax of 4 to 10 percent, two would be paying less than 1.5 percent, and Firm J would be paying 28 percent. Note that municipalities now have the option to impose a 1.5 percent tax on enterprise sales; in large part this tax is intended to finance the SSO that the municipality is taking over from enterprises. Such a tax levied (1.5 percent of sales) on each of the 11 enterprises would cover the expenditures of only three of the firms in this survey. However, the tax would apply to all the enterprises in the jurisdiction, including those not providing social services. Without information about the total volume of sales by enterprises and about SSO provided, it is not possible to determine whether the 1.5 percent tax would be sufficient to finance municipal provision of the SSO. Even so, regardless of whether the tax generates sufficient revenues in the aggregate, a reasonable hypothesis is that the tax is not likely to be adequate for SSO finance in all jurisdictions, given the uneven geographic distribution of enterprises in Russia.

Enterprise expenditures on social services are strongly related to the size of the enterprise, as shown by the simple linear regression results in Table 2. In the first equation, gross expenditures on the SSO are regressed against net profits; in the second equation, an alternative measure of firm size, total revenues, is used. Both regressions indicate that the magnitude of the SSO expenditures increases as the size of the firm increases. Variations in total revenues explain

more than 60 percent of the variation in social service expenditures.⁴ In the third equation set, expenditures per employee are regressed against the number of employees. While the coefficient on employees is negative, it is not statistically significant.

TABLE 2

REGRESSION RESULTS
(standard errors in parentheses)

1.	Gross Expenditures =	114,234	+	0.2335 • Net Profits	R ² =0.38	N=11
	on SSO (in 1000)	(165004)		(0.0098) (in 1000)		
2.	Gross Expenditures =	690,088	+	0.00769 • Total Revenues	R ² =0.63	N=10
	on SSO (in 1000)	(126205)		(0.00210) (in 1000)		
3.	Net Expenditures =	19.54	-	0.236 • Employees	R ² =0.16	N=10
	on SSO per employee	(10.48)		(0.194) (in 1000)		
	(in 1000)					

The data in Table 3 show some details on the types and levels of expenditures for the firms for which we were able to gather such information. It should be noted that not all firms reported expenditures in each category. In some cases this may mean that there was no expenditure in that category, while in others the amount may have been aggregated into another category.

⁴Gross expenditures are used as the dependent variable because it is available for more enterprises. Note that net expenditures on the SSO are used for Firms I and K. Also, Firm D is excluded from the second equation because we do not have total revenues for firm D.

TABLE 3
ENTERPRISE EXPENDITURES ON SSO, 1992
(in thousands of rubles)

	<u>Firm A</u>		<u>Firm B</u>	
	<u>Gross</u>	<u>Net</u>	<u>Gross</u>	<u>Net</u>
Housing and Utilities	232,843	177,284	6,640	5,845
Housing Maintenance	113,860	89,000		
Utilities	118,983	88,284		
Day Care	185,800	160,495	9,555	9,006
Sports and Cultural Objects	56,000	53,610	199	191
Clinics				
Other				
Total	474,643	391,389	16,394	15,042
Housing and Utilities as a Percent of Total	49.06	45.30	40.50	38.86
Day Care as a Percent of Total	39.15	41.01	58.28	59.87

TABLE 3 (continued)

	<u>Firm C</u>		<u>Firm D</u>	
	<u>Gross</u>	<u>Net</u>	<u>Gross</u>	<u>Net</u>
Housing and Utilities	252,746		285,500	
Housing Maintenance	46,551			
Utilities	206,195			
Day Care	136,564		362	
Sports and Cultural Objects	19,231			
Clinics	2,565		107,488	
Other	117,922			
Total	529,028		393,350	
Housing and Utilities as a Percent of Total	47.78	NA	72.58	NA
Day Care as a Percent of Total	25.81	NA	0.09	NA

TABLE 3 (continued)

	<u>Firm E</u>		<u>Firm F</u>	
	<u>Gross</u>	<u>Net</u>	<u>Gross</u>	<u>Net</u>
Housing and Utilities	52,266	50,773	2,600	
Housing Maintenance Utilities				
Day Care	22,630		2,400	
Sports and Cultural Objects	11,592			
Clinics	2,262			
Other	12,505		11,400	
Total	101,255	95,470	16,400	
Housing and Utilities as a Percent of Total	51.62	53.18	15.85	NA
Day Care as a Percent of Total	22.35	NA	14.63	NA

TABLE 3 (continued)

	<u>Firm G</u>		<u>Firm H</u>	
	<u>Gross</u>	<u>Net</u>	<u>Gross</u>	<u>Net</u>
Housing and Utilities	106,385	51,659	16,109	11,414
Housing Maintenance	24,594	23,810		
Utilities	81,791	27,849		
Day Care	18,433	18,431	13,511	11,208
Sports and Cultural Objects			6,784	6,337
Clinics	1,966	1,966	4,359	2,007
Other	35,577	30,923	3,508	
Total	162,362	102,979	40,879	30,251
Housing and Utilities as a Percent of Total	65.52	50.16	39.41	37.73
Day Care as a Percent of Total	11.35	17.90	33.05	37.05

TABLE 3 (continued)

	<u>Firm I</u>		<u>Firm J</u>		<u>Firm K</u>	
	<u>Gross</u>	<u>Net</u>	<u>Gross</u>	<u>Net</u>	<u>Gross</u>	<u>Net</u>
Housing and Utilities			37,216	32,435		13,200
Housing Maintenance			29,221	24,440		
Utilities			7,995	7,995		
Day Care		472	18,930	18,850		5,800
Sports and Cultural Objects			1,720	1,545		813
Clinics			4,312	4,312		23
Other			6,056	6,018		
Total		472	68,234	63,160		19,836
Housing and Utilities as a Percent of Total	0	0	54.54	51.35	NA	66.55
Day Care as a Percent of Total	NA	100	27.74	29.84	NA	29.24

SOURCE: Information provided by enterprises.

It is essential to note that housing (including utilities) and day care account for the bulk of the SSO expenditures. Housing ranges from 0 percent to 73 percent of total gross social service expenditures, and from 0 percent to 67 percent of total net social service expenditures. For the entire sample of enterprises, gross (net) housing expenditures are 55 percent (48 percent) of total social service expenditures. Gross expenditures on day care range from a low of 1 percent to a high of 100 percent, and for all firms in the sample gross (net) day care expenditures are 34 percent (23 percent). Enterprises also make expenditures on sports and cultural facilities, clinics, and other areas, but these amounts are generally quite small.

It seems clear, at least based on the results from this sample, that the issue of municipal takeover of the SSO expenditures is largely one that must deal with the provision of housing. Roughly half of the financial obligations attributable to the transfer of social services to municipal governments is attributable to housing. But expenditures on housing by enterprises probably understate the expenditures that municipal governments will be forced to undertake. Enterprises reportedly have done a worse job of maintaining their housing stock than municipalities, and thus much needs to be spent to repair these units.

If the housing stock is privatized, then this financial burden from the transfer of SSO will be substantially reduced.⁵ However, mass privatization of housing is not likely to occur in the near-term, and hence in the interim a way must be found to continue to finance the housing.

There are many barriers to the privatization of housing. Rents cover only a small fraction of the cost of housing, providing an incentive to rent rather than to own. Lack of financial institutions to issue mortgages limits the ability to purchase. The low construction quality and

⁵ Housing reform in Russia is discussed in detail in The World Bank (1993).

the need to make major repairs reduce the desire to purchase existing housing. Questions of land ownership inhibit the purchase of apartments. Real incomes have been falling making the purchase of housing more difficult.

In the face of these conditions, the Russian government has moved to create a private housing market. By the end of 1992, over 10 percent of the housing stock was privatized, compared to 1 percent in 1991. How fast the privatization of housing proceeds will depend upon how quickly the government moves to address the remaining barriers to privatization (*e.g.*, the establishment of condominium regulations and rent reform) and how the transfer of housing to households will be handled, especially what households will be required to pay for the housing.

To provide some additional perspective on the size of the housing activities of enterprises, consider the data in Table 4.⁶ If we assume that the number of individuals in a household averages three, then we can compare the size of the enterprise's labor force and the number of units of housing. For a majority of the enterprises (7 of the 12), the number of units exceeds the enterprise's labor force, in some cases by a sizable factor. Clearly, these enterprises are providing housing for far more than the families of their workers.

This last point was emphasized by the enterprise representatives in the interviews: It is also reflected in the third column of Table 4, which shows that the enterprise's housing is not just provided to its own workers. In several cases, only about half of the enterprise housing is occupied by families of enterprise workers. Enterprise officials noted, however, that many of the families of nonworkers were retirees of the enterprise. For many enterprises, day care is also

⁶Only partial information was obtained from Firm L, which is why it is not included in Table 3 but is included in Table 4.

used by non-employees. Enterprise officials also stated that only part of the labor force of the enterprise occupies enterprise housing or uses some of the other SSO.

TABLE 4

**ENTERPRISE PROVISION OF HOUSING AND
TAX DEDUCTIBILITY OF SSO**

<u>Firm</u>	<u>Employment</u>	<u>Occupants of Enterprise Housing</u>	<u>Percent of Occupants Related to Enterprise^a</u>	<u>Municipal Population</u>	<u>Percent of Total SSO Expenditures that are Deductible^b</u>
A	35,000	NA	NA	NA	NA
B	1,200	3,900	40	95,000	NA
C	NA	90,000	85	180,000	50
D	53,000	250,000	NA	1,500,000	NA
E	4,800	100,000	<50	150,000	70-80
F	800	2,500	80	150,000	50
G	5,150	12-15,000	50	50,000	32
H	8,000	8,500	NA	NA	NA
I	390	0	NA	NA	NA
J	3,000	10,000	70	100,000	50
K	590	3,000	NA	100,000	14
L	2,000	10,000	50	20,000	NA

SOURCE: Estimates provided by enterprises.

^a Percent of enterprise's housing population that are enterprise workers or family members.

^b Percent of total SSO that is deductible for purposes of determining company income tax liability.

There is the question of whether the social services provided by the enterprises are fringe benefits or in-kind wages. Fringe benefits are wages paid in non-monetary form, where generally the level of the benefit to an individual worker is based on pre-determined criteria. Most fringe benefits are available to all employees within the firm as a result of their employment. Other benefits are available to only selected employees based on such criteria as their position, tenure, or, in the case of day care, the presence of children. For the most part the social service expenditures of enterprises do not fit this concept of a fringe benefit. Social services benefit employees, but do not appear to be substitutes for wages. For example, housing provided by the enterprise is not available to all employees, and not all housing is provided just to employees. Furthermore, if housing is transferred from the enterprise to the municipal government, the employees will retain their apartments. SSO such as culture centers and sports facilities are quasi-public goods that in most cases benefit the entire community, not just workers. Only some SSO's, such as clinics and cafeterias that are available only to employees, can most likely be classified as fringe benefits.

On the other hand, while not strictly fringe benefits, some of the SSO may have been created to help recruit employees. By making housing available to new employees, the queues for other housing could be avoided. Thus, the benefit of enterprise-provided housing is the reduced waiting time and not the housing itself. Day care facilities make it easier for both parents, and especially females, to work. It is also possible that the social service expenditures were made as a way of using the surplus (profit) of the enterprise, to avoid penalties for paying excess wages to workers. Thus, while the evidence at hand suggests that most of the SSO are not fringe benefits, more careful analysis is required to determine whether the enterprises will

have to raise wages to compensate workers as a result of the transfer of SSO to municipal governments.

The importance of enterprise-provided housing to the community is also shown in column 4 of Table 4, which gives the population of the municipality in which the enterprise is located. In smaller communities enterprises can provide a substantial proportion of the community's entire stock of housing.

For example, Firm E provides two-thirds of the total housing units and Firm L provides one-half of the units in their respective communities. Also, in one of the suburban municipalities outside of Moscow, government officials stated that 75 percent of the housing is provided by the enterprises.

The final column of Table 4 shows the percent of the total SSO expenditures that were deducted in determining company income tax liability. This information was gathered in only some of the interviews. There is no single answer to this question. From the interviews it was not possible to determine which SSO were deductible. Some individuals said only housing and day care expenditures were deductible, at least in part, while others said all SSOs were eligible deductions. It is not clear whether this is the result of differences across jurisdictions, lack of information on the part of the interviewee, a translation problem, or ignorance or confusion on the part of the firm.

The actual practice concerning deductibility varied widely among these enterprises. For some social services the percent deducted approaches 100 percent of the actual expenditures, but on average the deductible amount is considerably less. The enterprises reported widely varying ranges of deductibility, in part because each municipality apparently sets its own standards (or

"norms") for the amount to be deducted and because the deductibility varies by SSO. The deductibility is based on standards established at the national level and cost of service provision established at the local level. For example, day care standards are established in terms of the number of teachers per child, supplies per child, nutrition level, etc. Each local government then determines the cost of providing day care within its municipality based on local prices. The cost is apparently determined by observing what enterprises spent in previous periods. For some SSO, deductible expenses are simply a percent of actual expenditures. In some interviews, government officials stated that, because of the high rate of inflation, municipalities are now setting the norms using actual rather than previous year expenditures. Consequently, it was believed that the percent that will be deductible may well increase.

Krasnogorsk (Moscow Oblast)

Krasnogorsk is a city of roughly 100,000 people, located in the suburbs of Moscow; there are over 140,000 people in the rayon. Employment is concentrated in industry and services.

According to government officials in Krasnogorsk, there are 210 enterprises in the municipality; of these, 14 provide some form of social services. Information about these 14 enterprises was collected directly from the enterprises by the municipality, for the purpose of establishing tax deductible norms for the various social services. This information is not complete and is less detailed than the information provided by the enterprises in the survey discussed above. However, these data contain all enterprise SSO expenditures in a single municipality, and, in combination with information on the municipal budget, it therefore allows

more precise estimates of the impact on the municipal budget of municipal takeover of enterprise SSO.

In 1992, total revenues of Krasnogorsk were R 926.4 million, of which R 785.2 million were own-source revenues; over 88 percent of own-source revenues were collected from the company income tax and the individual income tax. Total expenditures in 1992 were R 869.4 million. The budget classifies municipal expenditures on the SSO at R 330.2 million. However, a broader and more inclusive classification of social service expenditures indicates that total municipal SSO expenditures were R 644.7 million, or nearly three-fourths of total municipal expenditures. This broader classification includes such items as housing, utilities, food allowances, and allowances for mothers. Municipal expenditures on housing and utilities totaled R 124.2 million in 1992, or 14 percent of total expenditures.

For 1993 the revenues and expenditures of the municipality are budgeted at R 3.6 billion and R 4.2 billion, respectively. Assuming that the pattern of the SSO spending is unchanged from 1992 to 1993, total SSO expenditures by the municipal government will equal R 3.1 billion (using the broad classification) in 1993, and expenditures on housing and utilities will equal R 0.6 billion.

The data in Table 5 provide information on the relative magnitude of enterprise expenditures on social services. These data refer to the first quarter of 1993, because it is only for that period that information on enterprise revenues and profits is available. As with the survey information on enterprises, there is substantial variation across the 14 firms. Gross profits range from R 5.9 million (Firm 10) to R 2,755.1 million (Firm 3). Firm 3 is by far the largest enterprise in the city. It dominates other enterprises and the municipality in terms of the

TABLE 5
KRASNOGORSK ENTERPRISE EXPENDITURES ON SSO AND
ENTERPRISE ECONOMIC PERFORMANCE, 1ST QUARTER 1993
(in millions of rubles)

<u>Enterprise</u>	<u>Total Revenues</u>	<u>Gross Profits</u>	<u>Net Expenditures on Social Services</u>	<u>Net Expenditures on Social Services as a Percent of:</u>	
				<u>Total Revenues</u>	<u>Gross Profits</u>
1	57.3	8.7	11.99	20.9	137.8
2	62.7	12.9	0	0	0
3	NA	2,755.1	140.69		NA5.1
4	539.0	29.9	35.75	6.6	119.6
5	NA	NA	28.77	NA	NA
6	374.4	186.0	7.35	2.0	4.0
7	34.2	14.9	0.51	1.5	3.4
8	NA	NA	0	0	0
9	77.0	34.8	1.15	1.5	3.3
10	52.3	5.9	0.51	1.0	8.6
11	36.0	15.8	6.01	16.7	38.0
12	130.5	82.4	0	0	0
13	127.2	20.5	0	0	0
14	NA	NA	9.33	NA	NA

SOURCE: Information provided by Krasnogorsk (Moscow Oblast) municipal officials.

provision of social services.⁷ Net expenditures on SSO, relative to total revenues, also are subject to wide variation. This share is as low as 1 percent, and as high as 20 percent.

The potential burden on municipal governments from their takeover of enterprise social services is better illustrated in Table 6. These data show projected enterprise expenditures on the SSO for 1993 for all enterprises in Krasnogorsk that provide some social services.⁸ Total SSO expenditures are budgeted at R 2,400 million, of which 64 percent will be made by Firm 3. Over half of these expenditures will go toward housing and utilities. In fact, spending on housing and utilities represents the largest single category for 10 of the 11 firms with planned SSO expenditures in 1993.

Recall that planned 1993 expenditures on all SSO by the municipality are estimated to equal R 3.1 billion, of which R 0.6 billion are for housing. These enterprises, therefore, are projected to spend an amount equal to roughly three-fourths of the municipal expenditure total on social services. Further, projected enterprise expenditures on housing and utilities (or R 1.3 billion) are over double the planned local government expenditures in this area; indeed, the planned spending on housing and utilities by Firm 3 alone exceeds estimated municipal spending on housing and utilities. If the municipality is required to assume responsibility for the provision of all the SSO currently provided by enterprises, it is clear that the government will be placed

⁷At present, this enterprise is still government-owned, although the privatization process has begun. Municipal officials have expressed great concern about the impact on the municipal budget if the government is forced to absorb all of the SSO of this firm.

⁸Note that some firms included in Table 6 are shown as making no planned expenditures for 1993. These enterprises are included because government documents indicated that they had provided some SSO during 1992 or in prior years.

TABLE 6
PROJECTED ENTERPRISE EXPENDITURES ON SSO, 1993
(in millions of rubles)

<u>Enterprise</u>	<u>Housing and Utilities</u>	<u>Sports and Daycare</u>	<u>Cultural Objects</u>	<u>Clinics</u>	<u>Total</u>
1	26.21	0	0		026.21
2	28.68	0	0		028.68
3	796.76				255.88180.001,528.44
4	119.00			14.00	0143.00
5	98.19	48.77	0		0146.96
6	75.44	69.06	250.20		0394.70
7	2.80	0	0		02.80
8	0	0	0		00
9	4.48	0	0		04.48
10	2.97	0	0		02.97
11	29.97	14.36	1.50		045.83
12	0	0	0		00
13	0	0	0		00
14	68.80	7.26	0		076.06
TOTAL	1253.30	445.25	521.58180.002,400.13		

SOURCE: Information provided by Krasnogorsk municipal officials.

under severe stress, both in the short term (because of the immediate financing needs) and in the long term (because of the maintenance requirements).

The domination of social service provision by enterprises, especially in housing, is not unique to Krasnogorsk. In Balashiha (Moscow Oblast), officials stated that 25 percent of the total housing stock is the responsibility of the municipality, with the rest provided by enterprises. According to officials at the Moscow Oblast property committee, enterprises may sometimes own all of the housing in municipalities, and the level of SSO expenditures last year ranged from 7 percent of net profit of enterprises in the oblast to 90 percent of net profit.

CONCLUSIONS

This sample of enterprises is very small, it was not randomly drawn and it may not be representative. But the results of this survey do provide some evidence about the provision of social service expenditures by enterprises, and may help form some working hypotheses for a larger study. These general conclusions are as follows:

- Enterprise expenditures on SSO vary widely, both in terms of total level of expenditure, and relative to the size of the enterprise. Most firms, especially the smaller ones, do not provide any social services. However, expenditures on SSO by larger firms are significant and involve an extensive list of services.
- SSO may be provided to all workers of the enterprise, only to some of the workers at the enterprise, or to residents of the community. Thus, many of these services cannot be considered simply as fringe benefits or as in-kind compensation for the workers of the enterprise.
- Expenditures for housing constitutes the bulk of SSO outlays by most enterprises. While of no benefit in the short-term to the financial burden that municipalities will have to bear, privatization of housing and rent reform is a long-term solution to the transfer of responsibility for the SSO to municipalities.

- Much of the current expenditures on SSO made by enterprises are deductible in computing the company income tax, although the percent of the expenditures that are deductible varies by company and by municipality.
- The basic conclusion from this illustrative survey is that the transfer of SSO from the enterprises to the municipal governments will likely impose a large financial burden on the receiving governments. Additional research on the possibilities of increased user charges, and of the revenue potential of the local 1.5 percent tax on gross receipts, is necessary before a more definitive statement can be made.
- The transfer of the responsibility for the SSO has been largely postponed because most enterprises have agreed to continue to finance these services, at least for the present.
- Although the privatization laws and privatization decrees make it clear that enterprises are not to retain the property associated with the SSO, many of the enterprises interviewed expressed a desire to retain part of this property and to provide the associated social services.
- The necessity of continuing provision of SSO has had little impact on the privatization of the smaller enterprises because these enterprises do not provide substantial amounts of social services. It has had some impact on the privatization of the larger enterprises, but this impact is not easily quantified.

RECOMMENDATIONS FOR TECHNICAL ASSISTANCE

Technical assistance could be helpful in planning and implementing the transfer of SSO from the enterprises to the subnational governments. Based upon the analysis in this paper there are several steps that should be considered in addressing this issue. The support activities described here are aimed at providing confirmation and detail on the results reported in this illustrative survey, and exploring ways to accommodate the financial burden placed on municipal governments by the transfer of SSO.

Survey Of Additional Enterprises

The information on enterprise provision of the social services presented in this paper, is based on a small, non-random set of enterprises. The interviews concentrated on larger enterprises, enterprises that had either gone through or were in the process of privatization, enterprises that appear to be generally more profitable, and only enterprises in the Moscow and Chelyabinsk oblasts. The choice of interviewees was made in each case by oblast and municipal governments. It is important to obtain more precise and representative information to verify the accuracy of the findings in this paper before major programs and policies are designed and implemented. The sample must be considerably larger and must include smaller enterprises, enterprises that have not yet begun the privatization process, less financially successful enterprises, and enterprises in other areas of Russia.

Part of the proposed information gathering would reproduce the same information as contained in this paper but would be based on a large random sample of enterprises from throughout Russia. To the extent possible, the data should also be collected for more than one year. The survey should include consideration of:

- the income statement of the enterprise, including the annual costs of providing social services, the revenue obtained from their provision, and the tax treatment of these expenditures;
- the assets and liabilities of the enterprise, including the value of any assets used to deliver or maintain social services;
- the number of employees in the enterprise;
- the details of the enterprise's privatization (if relevant).

The technical assistance should involve first, a complete design of a questionnaire to be administered to participating enterprises. Second, this should be field-tested by a technical assistance team, making sure that appropriate representation of enterprises was included in the field test. Third, a mock-up of the analytic results from the field test should be reported, as a method of designing the analytic model that will be used to report the results. Fourth, a team of surveyors should be trained and given field experience. Fifth, the random sample should be drawn and the survey conducted. Finally, the results should be tabulated and analyzed. The work could be done jointly by the Russian Fiscal Analysis Unit and USAID advisors.

Survey Of Additional Municipal Governments

It is important to determine more precisely the additional burden municipal governments face from the takeover of enterprise social services. Without this information, it will not be possible to evaluate the effectiveness of alternative methods of financing the takeover by the government sector. As discussed in this paper, this is a complicated issue. Research is necessary to answer a number of questions:

- Are SSO absorbed at marginal or average costs?
- What is the "net" cost of absorption for each ruble of SSO transferred? Such calculations must take into account both the present deductibility of SSO for company income tax purposes, the local share of company income tax revenues, and the increased user charges/taxes that might be levied.
- What transition period is necessary?
- What continuing (administrative, operating and maintenance) costs will be absorbed by the subnational government?

Of course the biggest question to be answered is what is the total magnitude of incremental SSO costs that will be imposed.

Technical assistance may be offered to address these issues. A representative sample of municipalities should be chosen, and detailed case studies carried out to identify the exact implications for the public sector. This will require intensive field work and a special sample survey so that an estimate of the total cost implications can be made. It would be desirable to survey municipalities in which the enterprises that will be surveyed are located.

SSO As Fringe Benefits

Present law requires that nearly all SSO be transferred from the enterprise to the municipal government. While the analysis based on this survey concludes that most of the social service expenditures made by enterprises are not fringe benefits, more detailed analysis of this issue is needed. The policy requiring the transfer of all SSO should be carefully considered. While, in general, social services should be the responsibility of government, some of the expenditures that are classified as social service might be better treated as fringe benefits and retained by the enterprise. In order to address this question, it is necessary to determine the extent to which the social service expenditures are fringe benefits, *i.e.*, non-wage payments in lieu of wages. To the extent that the firm retains any of the social services as true fringe benefits, the burden on the municipal government is reduced.

It is necessary to survey enterprise-provided social services in much greater depth than to use the results of this survey to establish some concrete rules about what constitutes a fringe benefit and what constitutes a social service expenditure. One way to do this is to work within

the proposed enterprise sample to identify beneficiaries of each perquisite provided, and to try and determine the extent to which social service benefits capitalize into wages.

Privatization Of Enterprise Housing

The national policies for the privatization of housing now being developed could include special treatment of the enterprise housing stock that would reduce the burden on the municipal government. For example, the enterprises could be allowed to raise rents to a level that covered maintenance, utilities, and replacement costs; in return, the enterprise would be allowed to raise wages to a level that compensated the workers for the loss of a highly subsidized rent. This approach, however, is complicated by the presence of tenants who are not associated with the enterprise and by employees who do not reside in enterprise housing. Moreover, higher wages would mean a reduction in taxable profits or, perhaps, in employment.

Because of its complexity, this issue requires hard analysis before any policy is designed. It is necessary to review the housing reform proposals against the data gathered on the provision of SSO and to simulate the potential impacts on the costs of the transfer to subnational governments.

The major component of enterprise expenditures on social services appears to be for housing. This conclusion needs to be verified, and it needs to be supported with information about whether the expenditure is for construction, maintenance, supporting facilities, etc. Then the issue of transfer must be addressed. But because of its complexity, this issue requires thorough study in a context of the present housing reform proposals.

Revenue Instruments For Subnational Governments

Assuming that the conclusion holds that the cost of SSO assumption by subnational government is substantial, then it is important to evaluate the options for covering this additional cost. The two most discussed options are user charges and increased local taxes. At present, user charges for the social services provided by the enterprises do not appear to cover a significant portion of the cost. Consideration should be given to the possibility of raising the level of user charges. There needs to be a feasibility study to determine the appropriate level of user charges for each social service. This might be done as a simulation analysis using the enterprise and municipal samples.

If the responsibility for the SSO is to rest with the municipal governments, then consideration needs to be given to the more general financial resources of municipal governments. Beyond the ability to raise user charges, should the municipal governments be given the authority to impose additional taxes, and if so, what type of tax and at what level? Important technical assistance can be offered in the form of a feasibility analysis of the alternative local government revenue sources that might be used to fill this gap. The problem is complicated because the increase in SSO expenditures must first be estimated, and then the revenues from a general tax (presumably one of the 49 local taxes) must be estimated. This will require using the data from the enterprise and municipal samples, and developing a simulation model to evaluate the options.

In the absence of an agreement between the enterprise and the municipality that delays the transfer of the SSO until a certain date, municipalities face the prospect of soon becoming responsible for a large and unexpected increase in expenditures. Until a viable financing plan

can be put in place, consideration might be given to a program that would allow the municipality to obtain short-term budget relief. This might take the form of a grant from the oblast or central government. One important contribution of the technical assistance would be to evaluate the alternative transition mechanisms.

Compatibility Of Utility Systems

The transfer of some of the SSO objects appears to involve issues such as the compatibility of the governments' and enterprises' utility systems. Assistance could be provided in how the municipalities can physically integrate the SSO from the enterprises into their own systems. However, the interviews that were conducted only suggest that this is a potential issue, additional interviews and field work are necessary to determine the extent of the issue and the nature of any assistance provided.

Inefficient Size Of Facilities

Most municipalities will be forced to assume responsibility for the SSO of several enterprises. This leads to the possibility that the municipality will be forced to provide the social services at several separate facilities, including the municipality's existing facilities. Many of the transferred facilities may be too small to be economically efficient or maybe located in non-optimal sites. To the extent that this is the case -- and additional information will have to be obtained to confirm it -- then assistance to municipalities to help design an efficient structure could be useful.

Non-Privatized Enterprises

The SSO of enterprises that are privatized are to be transferred to municipal government. It is assumed, however, that SSO of enterprises that are not privatized, *e.g.*, those in the defense industry, will not be transferred. If this is the current policy -- and any follow-up should address this point -- should it remain the policy? Further, as part of the realignment of the responsibilities for the delivery of social services, is it appropriate and/or desirable for enterprises, even if state-owned, to continue to be responsible for social services?

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V. THE BUDGETING PROCESS

INTRODUCTION

This chapter describes and evaluates the current budgeting policies and procedures in the Russian Federation at the federal, oblast, and rayon levels. Within the context of the budgeting process attention is given to the roles of revenue estimating, budget development, budget execution, capital budgeting, and computer based information systems.

A summary of the major budget and financial management problems facing the Russian Federation are described to provide a context for the technical assistance recommendations presented. The technical assistance recommendations are both long and near term in nature; however, they are not meant to be exhaustive of the technical assistance needs and opportunities in the area of budgeting and financial management in Russia. It should be anticipated that as discrete technical assistance activities begin and progress, additional assistance issues and needs will be identified. It is suggested that USAID be able to give expedient responses to technical assistance needs identified during the initial implementation efforts.

REVENUE FORECASTING IN THE BUDGET PROCESS

The budgeting process can neither be described nor understood without first understanding the linkage with revenue forecasting. The Russian Federation has a complex and fragmented system of taxation which ultimately controls the expenditure side of the budget. This controlling influence is manifested in the following practices: (a) the prohibition of deficit budgeting at the subnational level; (b) the vertical integration of revenue sources; (c) the role of the State Tax

Service in collecting all revenues; and (d) the forecasting of revenues by the federal Ministry of Finance (MOF).

Consequently, the size and composition of the expenditure budgets are determined by the revenue estimating and collection processes. This state of affairs is problematic because it was stated repeatedly that the ability of the MOF to make accurate revenue forecasts is limited by the unstable economic conditions and the absence of timely and accurate financial data on the private sector activities, the activities of the STS in collecting revenues, and the actual expenditures of all levels of government by function or activity.

Central to this latter problem is the lack of an integrated and automated information system. For example, most of the budget expenditure reports at the initial level of preparation are completed manually. Furthermore, there appears to be a reluctance at the regional or oblast level to share with the MOF all of the tax data available even though the STS is a federal agency. Repeatedly, officials at all levels cited the need for appropriate computer software and hardware. This need is made even more critical by the current practice of rebudgeting revenues and expenditures on a quarterly basis, a practice necessitated by the unstable economy and extremely high inflation.

BUDGET ISSUES AND PROBLEMS

The issues and problems surrounding the budget process are numerous and complex. They continue to reflect the procedures and policies of a highly centralized system that prohibited or discouraged participation and input except at the very highest levels. The more immediate and specific budget issues are as follows:

1. The budget process in Russia remains top down; therefore, the budget officials are denied the value of the ideas and experience of budget officials at the lower levels of the intergovernmental system. As a result the focus of the budget process is very narrow in terms of time and substance; its time horizon is no more than one year, and it is almost totally preoccupied with preventing deficit budgets. Even though there are established national program goals manifested in the form of national "norms," there appears to be little formal relationship of these norms to defined national or subnational objectives. The process of developing these norms, rather than being a means of fostering ideals of unification, pride, and community participation, is perceived as being detached, irrelevant and unresponsive.

2. In terms of budget "activity" in the preparation and execution phases, it is extensive; however, it is at a very general level with limited utility as far as achieving meaningful reform and goal accomplishment. For example, numerous budget reports are prepared monthly, quarterly and annually, but they are not "budget" documents in any modern or contemporary sense. Their utility is primarily to track cash-flows to assure that expenditures are not made prior to the receipt of adequate revenues. These reports are not instructive as to what objectives are actually being met through these various expenditures. In other words the data are at such an aggregate level of detail that the dynamics of budgeting and implementation are not documented.

3. The value of the budget reporting system is further hampered by the generally low level of computerization, the absence of integration of those computer systems which do exist, the lack of adequate computer software and hardware, and the lack of understanding and appreciation of computer technology by the lower civil service ranks. Too much of the budget preparation, execution and reporting activities is done manually, and this impairs both accuracy and timeliness.

4. A related problem is that of employee utilization, morale and training. It appears that too many staff resources are devoted to relatively low level budget work thereby allowing little time and resources for analysis, evaluation, and planning. Training is not offered on a routine basis, which partially accounts for some of the staff resistance to computerization efforts. In general, government employees appear to have poor or out-dated equipment, poor salaries, and generally poor working conditions.

5. That there exists no sustained and coherent capital budgeting policy or assigned level of responsibility within the intergovernmental system is evidenced by the budget process itself and the condition of Russia's non-military infrastructure. Russia has tremendous physical and human capital resources. However, the aspirations of Russia and its people can not be realized absent a coherent and long-term capital plan which includes a greater variety of financing options than now exists. As Russia becomes more democratic, the citizenry and the international community will demand that expeditious attention be given to the country's environmental, health and transportation infra-structure needs.

6. A true audit function does not exist in Russia. The current budget inspection process appears to be relatively informal and intermittent. Improving the means of systematically and

routinely accounting for the expenditure of public funds will be essential to maintaining the integrity of the entire government finance system, sustaining the support of the general citizenry, and supporting any debt financing activities.

RECOMMENDATIONS FOR TECHNICAL ASSISTANCE

Helpful technical assistance can be designed and initiated to assist the Russian Federation during this transition period in all aspects of public budgeting, fiscal management, tax policy, and information systems. Some activities could begin immediately, and can yield near term results if jointly designed and initiated by U.S. and Russian public finance experts.

Budget Policy

Linking the budget to broad policy goals accompanied by more specific objectives, strategies and action plans will assist efforts to allocate resources according to preferences expressed through democratic processes. Such budgets will also allow the political leadership and the bureaucracy to react more positively and quickly to the changing priorities of an economy in transition. However, these kinds of budget policy and process changes cannot be achieved immediately; they are more intermediate or long term in scope and time. Nevertheless, the following technical assistance efforts could begin immediately:

1. Strengthening the pool of fiscal management specialists is a top priority if a radically different government structure is to characterize the Russian Federation of the future. Technical assistance could be provided in various sites in Russia, implemented by joint Russia-U.S. working groups. This kind of training will become more critical as the privatization effort expands; government service will become less attractive in the short term unless such service is viewed as an opportunity to acquire meaningful skills in fields such as budgeting, public finance, information systems and technology.
2. Prior to sending such training teams to Russia, it is recommended that significant training resources be first developed in the United States. This can best be done jointly by university and

government personnel through drawing on appropriate technologies and methodologies. However, the production of these training modules should be the result of a collaborative effort with teams of budget officials from Russia from all levels of government. Such collaboration will assure that the training modules reflect the information and skills most immediately needed and should forestall the temptation to send teams immediately throughout Russia in an uncoordinated manner and potentially disseminating mixed or even contradictory messages.

3. The teams of Russian budget practitioners would do the following while in the United States:

- acquire intensive graduate level instruction in budgeting theory and concepts, capital budgeting principles and practices, public finance theory in a market economy, basic revenue estimating methodologies, and an introduction to public accounting.
- augment the classroom instruction with budget practicums in federal, state and local government environments. This applied experience would require the Russian budget officials to participate in the respective budget phases in process at the time of their practicum.
- be assigned specific responsibilities in the preparation of instructional materials to be used in Russia by returning Russian nationals and American technical assistance teams. The tasks involved in preparing such materials would include, but not be limited to, planning and design of instructional manuals, forms, and procedures; production of such materials in the Russian language in both written and video media; and the design and production of instruction syllabi to be used in Russian universities or other training venues.

4. With some imagination, a state government budget office and a University could work together in other innovative ways. For example, the resources of a university journalism department in conjunction with the classroom instructors, US budget practitioners, and the Russian budget officials could team with a television station, either public or private, to prepare video instructional material in the Russian language. Ideally, these video materials could be enhanced by the application of computer based instruction. These support materials should be prepared by those developing and providing the basic instructional and experiential training. The assistance of the National Association of Budget Officers (NASBO) could be helpful because of its efforts in developing a series of training videos for use by state budget offices in the United States.

5. Using the planned NASBO series as a guide, fifteen or more videos could be produced. This medium could be used to treat such topics as the fundamentals of budgeting, review of funding approaches and philosophies, the economy and budgeting (demographic impacts, economic forecasts, economic development and tax expenditures), budget analytic methods, budgeting and intergovernmental relations, communication skills needed in all phases of the

budget process, and budget processes (operating budgets, capital budgets, debt financing, forecasting revenues and expenditures, and auditing).

Budget Information Systems

Without exception, Russian government officials recognize the need to establish integrated computer technology and systems. As a consequence of the still highly centralized approach to government finance in Russia, the current budgeting process involves manually prepared monthly, quarterly, and annual reports whose accuracy and usefulness is questionable. However, until overall national budget and program objectives are decentralized at the Federation level, the current reporting system is likely to remain in effect. Therefore, it is suggested that the following short-term and long-term actions be considered.

Short Term Actions. The amount of information available on the daily financial processes at both the national and subnational levels remains general. Therefore, prior to the actual design and application of computer hardware and software systems, an accurate and detailed operational description of the Russian budgeting and financial management system must be developed.

This information can probably best be obtained through the process of flowcharting. The benefits of using this tool will extend beyond the immediate needs for computerization. For example, flowcharting will not only provide a visual representation of the total current processes, but it will show the relationships between steps, functions and departments involved. It will also be helpful in identifying areas to target for training purposes; it is quite possible that extensive training may need to be provided in flowcharting itself. This tool is particularly useful in recognizing existing or potential process problem areas, redundant or unnecessary procedures, and

expose opportunities for process simplification. And lastly, it is very valuable in documenting and standardizing both current and proposed systems and processes.

It is recommended that at least three technical teams (one for each level of government: national, oblast, rayon) be sent to Russia for two to four weeks to inventory the quantity and quality of computerization currently used, define and chart the basic information flows and needs of the current reporting system, determine the availability of current software systems which offer promise of expedient modification and installation (if any); inventory and assess the availability and quality of Russian resources to develop software, and prepare a coordinated report as soon as possible. The members of these teams should be drawn primarily from the ranks of computer and systems information specialists in the US public sector. Each team should have individuals who have had both technical and management experience in the design and development of information, management, communication, and software systems. Ideally, these teams would assess the ability and willingness of the Russian budgeting and financial management personnel to flowchart existing processes and organizational relationships. This assessment would be useful in planning training modules.

A potentially important and useful resource in the budgeting and financial management areas in Russia is the proposed Treasury. The overriding objective is to extricate the treasury functions from the budget execution process. It appears that significant resources will be made available to the Treasury function. Substantial technical assistance should be provided to the treasury leadership to assure that its operations are appropriately computerized at the outset. It is possible, if done properly and at the outset, that the Treasury can replace and simplify many of the reporting functions of the current budgeting process and simultaneously serve as an applied

laboratory for the computerization of the entire budgeting and financial management system. The Treasury is sufficiently important that technical personnel could be assigned on site for at least two years. Consultation with the IMF on this matter is essential to assure that any assistance offered is compatible with that being offered by the IMF.

Lower level finance and budgeting staff are threatened by the proposed computerization of their work; several officials cited this attitude of staff to be a major concern. The successful transition from basically a manual system of budgeting, financial management, and public sector accounting requires that the training needs of lower level staff not be ignored, because in the short-run they will be critical to this transition.

However, their training needs in the near term will be quite different from those in the longer term. In the months ahead training modules should be developed which focus on both technical "how to" aspects of their work and the psychological issues. Some of the same training approaches used for higher level officials can be used, *e.g.*, video training modules, programmed computer-assisted instruction units, training manuals and guides. It is essential, however, that government decision makers understand that appropriate training of staff is an ongoing need because of at least two factors that the government will experience during this transition: (a) technology and systems will change rapidly, hence obsolescence will be a continuing challenge; and (b) as the proficiency level of public servants improves in the use and application of computer technology, they will leave government employment for better career opportunities in the growing private enterprise sector.

Consequently, in the near term it is recommended that technical assistance resources be used to train "the trainers" in computer skills. This training should have two components:

training of a cadre of Russian training personnel in the United States in government training facilities. Many state and federal agencies have established permanent computer training facilities completely equipped with computers and related support equipment in order to provide "hands-on" instruction and training. The Russian training personnel not only would be taught the technical aspects of computer usage, but would be instructed on how to establish, manage, and maintain permanent computer training laboratories in Russia. Second, several permanent computer training laboratories should be established in Russia, to be staffed and managed by professionals from the cadre trained in the United States.

Long Term Actions. In a nation as large and diverse as the Russian Federation, reliable and accessible communications will be critical in acquiring and transmitting financial data and other budget related information. A comprehensive technical assistance program should include an exploration of the availability of satellite communications channels owned either by the RF or the USA similar to those being used in the US under the rubric of "distance learning."

Because of the rapid changes in and the relatively high initial costs of telecommunications technology, it is recommended to form a small team of government communications specialists along with representatives from the private communications sector who are knowledgeable about the differences in U.S. and European communication systems. This team should be charged to assess the current communications system capacity in Russia with particular emphasis on the appropriateness of using satellite technology. The work of this team should include evaluating the communications system being proposed for the new Treasury. It has been reported that the

proposal is to use satellite communications for data transmission. The joint use of communication systems should be encouraged.

Strategic Planning, Program Evaluation, and Cost Accounting

The Russian Federation should establish a system for ordering the relative priorities of government expenditures, and the procedures to identify the skills and technologies required to determine the effectiveness of government programs relative to their stated (or unstated) objectives.

It is recognized that these activities are not the most critical, immediate budgeting and financial management tasks facing the Russian Federation. However, the techniques and approaches of strategic planning, program evaluation, and cost accounting are conceptually and actually linked. Therefore, it is recommended that training and instruction modules and case studies be developed in each of these areas, and that federal and subnational budget officers undergo training in these areas.

VI. FISCAL FORECASTING AND INFORMATION SYSTEMS

INTRODUCTION AND SUMMARY

This chapter summarizes the processes, problems, and potential for technical assistance in the fields of revenue forecasting and estimation, expenditure forecasting, and systems of fiscal information. Ongoing technical assistance by other organizations also will be described.

The main forecasting, data and financial management problems faced by the federal and subnational governments are as follows:

1. At all levels of government, the methodology used to forecast revenue is highly aggregated. There is no use of micro-level data of any kind. The federal government's forecasting approach is more complex than that of other governments, mostly because of the number of taxes estimated.
2. The task of estimating the impacts of changes in the tax law, both on aggregate revenues and on the revenues of individual oblasts, has not yet taken on much importance.¹
3. In practice, expenditure forecasts are not made. Officially, norms set by the federal government are used to determine future expenditure levels and to forecast expenditures, but in practice, simple growth rates are used in most cases.
4. There is no long term fiscal planning, *i.e.*, planned adjustments of revenue or expenditures to achieve budgetary balance. Part of this is due to the high rate of inflation, part to the difficulties of forecasting when tax structures and expenditure responsibilities are changing dramatically, part to a paucity of appropriate data, and part to a lack of experience in this area. All budget forecasts are made for a single year.
5. Capital expenditures are not a component of the regular forecast of the government budget. Lists of capital expenditures are submitted by various levels of government during the budget process, but no rigorous evaluation is undertaken. Capital expenditures do not appear to receive preferential treatment, and in many cases, they seem to have a residual claim on budget resources.

¹ There are exceptions to this. The Moscow Oblast soviet has invested in revenue estimation.

6. There is significant potential to establish a fiscal information system. All of the appropriate data (planned and executed budgets at all levels of government, tax revenues, socio-economic and demographic, and information on profits and expenditures of enterprises) are now collected at some level of government. But, data transfer and coordination among agencies is problematic. The data transfers are mainly hard-copy; there is little reliance on computers. Timing is a particular problem because some data are transferred through four or five agencies. Data are not currently coordinated by the various federal offices, but most data do reach some federal office.

7. There is insufficient computer hardware and software available to either develop a fiscal information system or to carry out a modern approach to forecasting.

8. There is a shortage of trained personnel to carry out the forecasting function at necessary levels. There also is a lack of trained personnel in the areas of budgeting and data collection.

9. There is concern in the State Tax Service that a lack of audit training has led to significant underreporting and underpayment of taxes by enterprises.

10. The reliance on aggregate data has frustrated attempts to estimate tax bases; the current system of forecasting utilizes relatively aggregate data.

The government is attempting to address these problems. The federal government and the Moscow Oblast finance office and local soviets have moved toward more advanced methods of revenue forecasting.² Consideration has been given to computerization of various data sources, and in some cases this has been carried out. The MOF utilizes the computer resources of FINTECH, a joint-stock company, while the STS has begun investing in their own computer departments. Expenditure forecasting and capital budgeting practices have not been developed. This is due to the enormous problems and uncertainties associated with the financing of social sphere expenditures and to the legislative changes in the assignment of expenditures.

The federal and subnational governments are currently receiving technical assistance in a variety of areas related to fiscal administration, including the development of information

² Both the Supreme Soviet and the Moscow Oblast soviet have some capability to estimate the revenue implications of changes in the tax code using aggregate level data.

systems. The IMF has begun a program to register enterprises and individuals and compile payment information for the VAT. The program is underway in two rayons. The IMF plans to extend this work to other taxes. The German, US, and British governments as well as the World Bank also have supported the Russian government in advancement of fiscal planning and control techniques.

Nevertheless, the problems in this area, and the need for technical assistance, remain considerable. This could take the forms of (a) "training," broadly defined as formal and on-the-job; (b) the development and implementation of modern procedures and analytic models; and (c) the provision of necessary software and hardware. The following might be considered:

1. Technical assistance in recasting budgeting procedures that would rely more heavily on information systems.

2. Training in the area of revenue forecasting to develop the use of both micro-simulation and econometric approaches. Such approaches would develop tax bases utilizing data on income, profits, expenses, etc. The micro-level data base development would be central to such training.

3. Assistance in the design and implementation of a fiscal information and management system accompanied by a data set containing socio-economic and demographic data. Such assistance would include data collection, computerization, and the development of on-line system of data sharing. At the federal level (and possibly for one or two large oblasts) this system would be integrated with the tax modeling and forecasting systems.

4. Software development for revenue and expenditure estimation.

5. Training in the field of expenditure forecasting and cost-benefit analysis.

6. Training and model development for tax audit procedures.

7. The development of a daily fiscal monitoring system for the federal government, in conjunction with the establishment of the federal Treasury.

REVENUE ESTIMATION

Ministry of Finance (MOF)

The MOF is responsible for the official revenue forecast of the budget of Russia. Within the MOF a revenue forecasting department is responsible for preparation of the annual forecasts. The MOF is also responsible for providing "official" revenue estimates of proposed changes in the tax law, but its involvement in this activity has been limited.

The forecasting methodology is relatively simple.³ The MOF uses as its main forecasting tool macro economic indicators (GDP, price levels, national income, profits, and wages) developed by the Ministry of Economy (MOE). These indicators are estimated for the entire country and for each individual oblast, and then used by the MOF to forecast profits, wages, and output levels.

The economic indicators are the basis for revenue forecasting. The forecasts are based on "current law," but adjustment to current law has become increasingly difficult due to the large number of significant changes in the tax law over the last two years. The economic indicators are not necessarily updated by the MOE when the law is changed. As a result, the MOF may be operating under economic assumptions that are not consistent with the tax law (e.g., that projected levels of value added will not be effected by a substantial reduction in the value added tax rate). In some cases, the MOF does have input into the MOE forecasts of economic indicators, but typically, they are taken "as given."

The personal income tax forecast is based on the wage fund projected by the MOE. The minimum wage not subject to tax (standard deduction) is set by law, and an estimate of this

³ Information regarding the forecasting and revenue estimating methodology was provided by Mrs. Zupkova, the head of the revenue estimating and forecasting division.

amount is deducted from the forecast of the total wage fund. The only other major deduction is the child benefit deduction. It is calculated using a simple model based on historical statistics on family size.⁴ Once the two deductions are made (standard deduction and child benefit), the current law tax rate is applied. The personal income tax is not a large revenue source by comparison with the enterprise income tax and VAT, but is an important source for some local governments.

The company income tax is estimated from the MOE forecast of company profits, with few adjustments made by the MOF to the forecast of profits. Enterprises now make annual income declarations, but this is a new practice and these data are not used to forecast income tax revenues. The MOF does estimate deductions for social sphere expenditures based on data from the STS, and from balance sheet information from the enterprises.⁵ The MOF also uses estimates of the wage fund and estimates of production cost made by the MOE and State Committee on Prices (SCOP). The enterprise profits tax is then calculated by subtracting wages, social sphere expenditures, and material inputs. Firms send their annual consolidated income statement to the State Tax Service (STS), and though these statements can be shared with the MOF, there currently is no coordinated use of this information.

The value added tax is the largest revenue producer for the central government. The VAT base is complicated and therefore difficult to forecast. The forecast is not done by industrial

⁴ The estimate of the number of children appeared to be the most difficult part of the individual income tax forecast. In some territories the family size is very large and difficult to estimate.

⁵ This estimation is complicated by the fact that not all expenses are deductible. The STS data contains total deductions (including those for the social sphere, compensation and material inputs) and the balance sheet information contains total social sphere expenditures, including non-deductible expenditures. Nevertheless, the MOF estimates that approximately 90% of social sphere expenditures are deducted.

sector, rather an overall forecast is made, and then divided among sectors. The VAT base consists of: income, the wage bill, surcharges, depreciation, other monetary expenditures, and excises. For the 1993 budget, this base equalled 36.8 trillion rubles (in March 1993). To calculate the tax base, macro economic indicators are taken from the MOE, using the December price index.⁶ These macro indicators are the level of enterprise income, the total value of the wage bill, and the output level.

The taxable base is computed for the entire country and for each region. Exemptions calculated by the MOF include turnover from exports, material costs, in-kind salaries, and other services and turnovers. For the 1993 budget, these exemptions total 10.28 trillion rubles. Each exemption is calculated separately, and not linked to any computer model. This estimated base is broken down into two groups: those with a tax rate of 10 percent (children's products, food) and those with a rate of 20 percent (all other goods). The disaggregation is based on the previous year's production of these goods. The final calculation for the VAT revenue is to multiply the taxable base by appropriate rate. The 1993 forecast for domestic VAT is 4.4 trillion rubles. The VAT on imports is calculated similarly, using forecast data from the MOE on imports. The revenue forecast of import VAT is 816 billion rubles for 1993.

One person in the MOF is responsible for all of the forecast work on the VAT. The staff is small -- a very few people are responsible for most of the revenue forecasting for the budget. There is little computerization, so time constraints are an issue. "Quick" calculations are unheard of. There does not appear to be an easy way to make adjustments to the revenue forecasts since

⁶ When the revenue forecasts are updated, they use the most recently available price forecast from the State Committee on Prices.

many of the calculations are made by hand. As new data come in, or as the tax law is adjusted, or the economy changes, the staff is forced to start over almost from the beginning.

In summary, the revenue estimating procedure is primarily an application of the growth rates and adjustments to aggregate tax bases estimated by the MOE. The revenue forecasts for the budget are produced with macro level data that in many cases are not even disaggregated by industry. The office does not take account of compliance rates or other behavioral effects induced by taxes. In fact, there does not appear to be data available to do a proper forecast. The office is involved in producing revenue estimates of legislation, but they do not appear to be a key player in this process. A lack of computerization and trained personnel makes adjustments to the forecast time-consuming and difficult.

There is a great need to improve the data base available to the MOF in order to improve the revenue forecasting practices of the MOF. Micro-level data on enterprises, property holdings, and individual taxpayers would enable the MOF to more accurately forecast revenue by type of industry. Such data would also allow the MOF to calculate true tax bases by industry, and would be a step toward estimating the behavioral impacts of taxation. Micro level data would enable the government to develop (or evaluate) revenue forecasts for each oblast, and to simulate effects of tax changes on the overall revenue base, and by oblast or rayon. Finally, there is a research function to be served with such a data base. As the market economy develops in Russia, there will be an increasing need to understand how the tax system is affecting the decisions of economics agents. Inevitably there will be calls to adjust the system to promote activities such as savings and investment, to stimulate aggregate demand or to cool down a high rate of

inflation, and to change the distribution of tax burdens. Micro level data will be necessary for the design and evaluation of such policy initiatives.

Territorial Governments

Varying degrees of sophistication are used to make revenue estimates at the oblast, rayon, and district levels of government. The Moscow Oblast finance office relies directly on the enterprises for basic data, and on macro indicators estimated by the MOE for each oblast (estimates of these indicators are not made at the rayon level).

The Moscow Oblast uses the same basic methodology that is used by the MOF to compute tax liability for each major tax. They then apply the sharing rates to determine their level of revenue.⁷ In most cases, the revenue forecast derived is very similar to that of the MOF. There is some computerization of the forecast procedure in a spreadsheet-type form, but there is no formal model. In some respects, it appears that the Moscow Oblast is as well suited as is the MOF to make new forecasts when there are changes in the tax law because the Moscow Oblast has more disaggregated data.

The finance department of Chelyabinsk Oblast uses a more simple revenue forecasting system. Revenue forecasts use the previous year's revenue as a base. Using tax collections, they back-out the previous year's output for the enterprise income tax. They then apply a growth rate to total output. This growth rate is the price-adjusted, expected growth in output (the price index is determined the Committee on Prices and the expected growth in output is produced by the

⁷ This was an especially difficult task in fiscal 1992, because budgeting was by each quarter and the tax sharing rates were often decided after the quarter was well underway.

MOE). Other major taxes are forecast by some general inflation rate applied to tax collections. Most of this process is not computerized.

The Odenisova rayon finance office uses a simple extrapolation method to forecast revenue. The estimates for all forms of taxes use the previous year's collections to back-out the tax base. Assumed growth rates for property value and profits are based on the MOE's price index forecast. In all cases, the revenue forecasts are static, *i.e.*, there is no accounting for growth in the number of industries, employees, or property ownership. Typically, aggregate data are used to forecast revenues. In Lubertsy Rayon, the finance office works directly with individual enterprises and uses the enterprise income projections to forecast tax liabilities attributed to enterprises. In this case, the revenue forecasts may not be consistent with the macro indicators produced by the MOE. Few of the data used to produce revenue forecasts are computerized. The information from enterprises comes to the offices in hard-copy form. Data are extracted from these forms and sometimes (in one rayon visited) are entered into a computer. There is some use of spreadsheets to calculate revenue forecasts, but the data are not used for analysis, such as of tax burdens or taxpayer compliance.

The finance departments in rayon offices do not analyze the effects of proposed legislation on their tax revenues before the law is passed. These local offices tend to be reactionary, and simply re-estimate revenues once the law is passed. They do not appear to take part in the debate over new legislation. In most cases these officials see little need to estimate revenue impacts, in part because the local governments have so little control over taxation and expenditure assignment.

There is some variation among city and rayon governments in their revenue estimating methodology. They use either a totally aggregated system in which they simply grow the previous year's revenues by some MOE adjustment factor, or they use enterprise projections to help determine their forecast. In some cases, a combined approach is used. In the more sophisticated systems, spreadsheet programs are used once data are obtained, but in general there is a limited use of computers. In most cases, personal computers are used primarily for word processing.

With some fairly simple advances in the collection and treatment of data, the current system of revenue forecasting could be markedly improved for the smaller local governments. Under the present system, most taxes paid to rayon budgets come from enterprises. Even the records for the individual income tax payments through withholding are kept primarily at the enterprise level. If enterprise data are kept up to date, they can serve as a reasonable source of information for local revenue estimation as well as for local tax administration. One could argue that the needs for tax information are especially great at the lowest level of government in Russia. The local governments have been assigned new and important expenditure responsibilities, and they are subject to discretionary changes in sharing rates and in subvention policies at both the federal and the oblast levels. Moreover, they are probably in the best position to capture the data necessary to compile a comprehensive micro data base, since they work directly with the rayon STS office, which is responsible for assessment and collections from enterprises.

The oblast governments are in need of a more adequate system of revenue forecasting. Since the oblast is responsible for deciding on the distribution of revenues among the rayons, it

is in their best interest to have information by revenue type and by rayon. The current system of using aggregates does not give them the resources necessary to determine why growth in revenue is occurring in some regions and not in others. Computerized information on enterprises, including location, wage bill, sales, etc., would enable the oblast to determine true tax bases. Also, as the tax system changes, these data will be needed to estimate new or expanded taxes. Without such information, it is difficult to see how the oblast can plan its fiscal behavior or make decisions about revenue sharing with its constituent local governments.

State Tax Service

The STS also develops a forecast of revenue. While all levels of the STS (federal, oblast, and rayon) purport to make estimates, the federal level uses the most advanced forecasting methodology. However, none of the STS offices use micro-level data for revenue forecasting. The central STS has a revenue forecasting department. They utilize the main indicators produced by the MOE (prices, output, profit, wage fund) to forecast revenue. They do not estimate VAT or enterprise income tax revenues by sector; they simply provide broad, aggregated totals of collections. The STS does not forecast revenue by level of government, rather they produce a forecast of total revenue collections by region. The forecasts produced by the STS are used as control figures. The STS admits that at this time, they do not know how much of the difference between actual and forecasted collections is due to compliance problems and how much is due to forecast error.

In the Chelyabinsk Oblast STS office, revenue forecasts are produced by applying a growth rate to previous year's collections. The growth rate is based on the forecast of the growth

in prices and output (produced by the MOE). It is not apparent why the STS makes the forecast, as they claim to use the MOF forecast as a control figure. In the Moscow Oblast, the STS is more innovative in its forecasting approach. The STS uses both previous year's collection data and balance sheet information from enterprises (in aggregate form by rayon). They estimate deductions by examining the differences between the two data sources. They then use growth factors from the MOE forecasts.

The rayon offices of the STS forecast revenue in much the same manner as the rayon finance offices. In the Chebarkhl Rayon STS office, specific enterprise balance sheet data and enterprise projections of profits and employment serve as the base for revenue forecasting.

The revenue forecasting methodology is not well advanced at any level of the service. There is no discussion of the use of micro-level information, and there is a continued reliance on the MOF for methodology. While this reliance may be acceptable, the STS should, at a minimum, develop the tools to analyze and question the forecasts of the MOF. The STS is more concerned with collections and underpayments than the MOF. The STS is responsible for achieving as close to 100 percent taxation of available bases as possible, while the MOF is interested in collections. The STS should also have the best access to data, including tax payments, declarations, audits, and balance sheets, making it a key player in forecasting. An integrated forecasting department within the MOF might include representatives from the STS. In such an approach, the MOF would be responsible for forecasting with input by the STS.

EXPENDITURE FORECASTING

There is a general consensus among practically all officials interviewed that there is an official expenditure forecast policy, but that in practice a different method is used. The official method of expenditure forecast (for all levels of government) involves the use of a series of "norms" or formulae to determine expenditure need. These norms include such items as books, paper, other supplies and teacher hours per student (for education), medicines and doctors per person (for health), etc., and are developed by the functional departments within the MOF.

The MOF officially uses these norms to project expenditures for the federal and oblast level governments. Expenditures are projected for one year only and the estimates are made by major department (education, health, transportation, etc.) The MOF determines the minimum level of expenditures for each department, by oblast, using the norms and the official forecast of prices. The MOF has insisted that they rely on the norms to produce the expenditure forecasts, but that the norms have not changed very much over the years. The norms for the entire country were produced under the old regime, and they have not been updated with changes in the composition of the population and changes in the economy.

At the subnational level, expenditure forecasts may be treated differently by different oblasts. For example, in all oblasts, the official expenditure forecast is made using the norms set by the MOF. The finance officer calculates total expenditures by department for each rayon (not by specific school, hospital, etc.). These "norm" expenditure calculations serve as the minimum expenditure needed, but may be inflated before presentation to the MOF. However, due to the difficulties of estimating changes in population and prices, in both the Moscow and Chelyabinsk oblasts the officers tend to use a "growth rate" approach. Expenditures by budget

department are grown at the general level of inflation (using projections from the SCOP) "plus some additional amount of growth." This additional increment is not determined with the use of an expenditure model -- in the past year it has been "assumed" in the range of 3 to 5 percent. The oblast level estimates differ from those made by the MOF because of some regional differences in the costs associated with inputs and because of the diversity in services provided by the rayons. The MOF uses national and regional averages of population to determine expenditures while the oblast takes into account more specific factors (such as the composition of the population).

The final layer of expenditure estimation is at the rayon level. The experience at this level is similar to that at the oblast level: expenditures are officially calculated based on the norms. However, in the rayons visited by the mission, officials described their forecasts of expenditures as last years expenditures inflated by a certain percent. The growth rate was most often determined by the growth in major input prices, wages and fuel.

At all levels of government, there is little computerization of the expenditure forecasting methodology. When computers are used, it is to perform simple calculations. At some levels of government, the forecasts are made by hand. In all cases, expenditure projections are made only for one year.

Capital expenditure forecasts are made separately, and are not contained in the general expenditure forecast. At the federal level, the MOE does not separately estimate capital expenditures. The oblast government does forecast capital expenditures, but on a year-by-year basis. Prior to 1992, the oblast government was responsible for financing capital investment projects of the rayons. At the present time, the assignment of capital investment responsibilities

is in flux. However, the oblast level Committee on the Economy still develops the list of potential capital investment projects, with input from the rayons. There appears to be little in the way of long-term capital investment forecasting.

The same problems with expenditure forecasting are found at all levels.

- There is no long term planning for capital expenditures or for growth in current expenditures.
- Expenditures are not "forecast," rather they are budgeted using simple methods of growth over the previous year.
- There is no concept of fiscal planning, in part due to the changes in expenditure responsibilities, rapid inflation, and changes in the revenue structure.
- The current official method of "norms" is based on an old view of the provision of public services, and may lead to an inappropriate level of services. The norm or growth method of forecasting may be relatively accurate when there is government control of prices; however, once control is diminished, all levels of government need to restructure their forecast methodology.

FISCAL INFORMATION

The first component of a fiscal information (management) system is a data base related to budgets of all levels of government, revenue collections, population and socio-economic information. The data should be made available to all practitioners in a timely manner. Hardware and software support for data collection, transfer and analysis are essential inputs to a modern fiscal information system. Data transfer to a central unit for compilation should also be done in a timely manner. The second component of a fiscal information and management system is a system of daily monitoring of the budget execution. Information regarding revenues and expenditures should be available so that the financial officers know their budgetary situation at any given time.

In general, a fiscal information system is critical to the advancement of fiscal planning. Many industrialized countries use such a system for budget planning, analysis of their tax and expenditure systems, and questions of intergovernmental relations. Consider the following three uses of such an information system. First, this data base can provide information necessary for budgeting purposes: historical growth patterns in revenues and expenditures, changes in the composition of the population, and detail on tax bases. Without such information, careful expenditure planning is not possible. Second, depending on the sophistication of the system, it can be used in estimation of the actual tax base in the country or in a territory. Third, the information may be used to simulate impacts of changes in tax and expenditure policies.

The data that support a modern fiscal management information system may be collected at a macro level (industry or territory) or at a micro level (enterprise or individual). What data are collected and at what level of aggregation will determine the uses of the system, a fact that underlines the need for careful planning of the system. The remainder of this section discusses the current status of data collection and data transfer. The discussion is structured by type of data, with a synthesis of all of the data sources in the conclusion to this section.

Tax Revenue Data

The State Tax Service (STS) is responsible for collection of tax payments made by enterprises and individuals. These data typically come to the rayon level STS from the banks at which tax payments are made.⁸ The payment data come in hard copy, on a form with the

⁸ At least one exception is in the Moscow Oblast where banks sent payment receipts directly to the Moscow Oblast finance office. The finance office in turn sends the receipts to the oblast STS office.

name, address, contact person, date of payment, bank account number and the amount of payment to each level of government.⁹

Aggregate level data on type of tax payment by level of government is passed from the rayon STS to the oblast STS two times per month. At the oblast level, the data are verified, based mainly on the monthly forecast of revenue. The data are then sent to the federal level STS in the form of a hard-copy table, in the form of monthly, quarterly and annual reports on taxes paid by type of tax and level of government. These reports are shared monthly with the MOF and the State Committee on Statistics. The STS does not currently send updated information regarding late payments, refunds, penalties, etc. to the MOF or SCOS.

The central office of the STS has begun to develop software programs to computerize enterprise registration and payment information. The software is designed in the central STS office and it is currently being distributed to territorial STS offices. The registration numbers and collection information are input at the rayon level, again using the payment records forwarded by the banks.¹⁰ Some rayons are utilizing software developed by private contractors for the same purpose. In general, the software serves as a database only, not a tax calculator. A demonstration of the software was given by the STS office in Lubertsy Rayon. There, information on payments made is entered and actual payments due are calculated by hand and then also entered into the program.¹¹ The software is capable of performing only one

⁹ Some enterprises report directly to the oblast or even the federal government. In these cases, the bank receipts go directly to the STS at those levels of government.

¹⁰ To date, the computerization of these data has concentrated on the VAT and on payments by individuals with more than one job.

¹¹ Actual taxes due are calculated using monthly reports from the enterprises.

calculation -- to determine the difference between actual payments and the tax due for enterprises and individuals. In Moscow Oblast, over 50 percent of the enterprises are registered, using software similar to that found in Lubertsy. The rayon STS offices enter tax payments by registration number, and then send the computerized information on disk to the Oblast STS office. This computerization of the STS was not found in other oblasts that the mission visited.

The IMF is currently assisting the STS with registration of enterprises and computerization. The IMF program will develop software to register enterprises, compute tax liabilities, and account for payment information. There are two rayons involved in a pilot project: Lubertsy and Tagansky. The pilot projects involve computerization of the enterprise declarations for the VAT. In Lubertsy, 15 computers will be set up in an office for the VAT project. The work is to begin on a sample of 200 enterprises. The software was not available at the time of our visit to Lubertsy, but the head of computerization believed that the software already in use by the Lubertsy Rayon STS was similar. The IMF program in general provides a fertile area for co-operation among the IMF, USAID, and the STS in the areas of fiscal information and computerization. The IMF project is a long-term project, eventually extending to more local STS offices and expanding to the enterprise income tax. USAID may provide assistance in expanding the project.

Actual Budget Execution Data (Revenue and Expenditures)

Forecasted budgets for all levels of government are finalized by the respective soviet. Due to the top-down nature of budgeting in Russia, there is a significant amount of information

transferred among the levels of government, including planned revenue and expenditures and actual revenue and expenditures.

The finance officers of the oblasts and rayons are usually in charge of making budgetary disbursements. Budgetary disbursements for expenditures are made by the finance officers on a daily/monthly basis, depending on the size of the government. The same officers play a large role in daily/monthly monitoring of their government's expenditures and revenue and therefore serve as an obvious agent for compilation of budgetary data. Information regarding revenue is sent to the finance officers by the local STS. In many cases, the close relationship between the finance officers and the STS allows a free flow of information so that the STS promptly informs the finance office about incoming revenue. The banks also provide information to the finance offices regarding deposits into the government's account. But, again, most of the data transferred are based on a manual system.

The rayon and oblast finance offices produce aggregate monthly reports of actual revenues and expenditures, by major type of tax revenue and by expenditure department. The rayon, town, and district government reports are consolidated at the oblast level and the consolidated report is then filed with the budget execution office of the MOF. These aggregate reports are made on a monthly basis, while more detailed reports are made on a semi-annual and annual basis. The MOF has provided the various levels of government with software to produce a hard copy of the consolidated reports. The transfer to the MOF is not computerized; the MOF receives the hardcopies from the oblasts and the MOF is responsible for entering them into the computer. Many finance officers expressed hope that this system of information transfer eventually would be computerized.

Territorial budgets are analyzed and processed in the MOF by two separate departments.¹² The department that processes the data also produces the consolidated budget for the country. A staff of 21 people in the MOF and 8 people contracted through FINTECH are responsible for producing the consolidated budget for the country and for collecting and producing reports of the executed budgets for all territories (oblasts, republics, Moscow city, St. Petersburg city, and krais). The executed budgets are sent by local governments to the MOF and the budget processing department consolidates some fields by hand and some with the use of spreadsheet-type computer programs. Most of the data are input using the central computer system at FINTECH. This process is largely mechanical; there are few calculations made and the output is a report that contains the executed consolidated budget for Russia. Although data are received monthly, due to difficulties in communications and lack of staff, the consolidated reports are not input into the computer on a monthly basis. In fact, the executed budget report for 1992 had not been finalized as of June 1993.

For purposes of developing the consolidated budget, the MOF budget department uses inputs of revenue and expenditure forecasts from various departments within the MOF. The physical consolidation of the individual departmental reports is done both within the budget office and at FINTECH. The software program at FINTECH is used to tabulate the budget, but can also be used to calculate the redirection of revenue among levels of government if the sharing rates are changed. Actual budget data must be input from the hardcopy reports forwarded by the finance offices of the various levels of government.

¹² The same office produces the budget forecast for the entire country using inputs from other departments in the MOF. This office is not responsible for analysis of forecasted or executed budgets; it was described as a group that "handles the data and produces the consolidated budget."

Enterprise Expenses, Profits, and Revenues

Data from enterprises are received by various government agencies, in various forms and levels of aggregation. Enterprises are required to report the following information to the rayon level STS on a quarterly basis: total sales, deductible expenses (not disaggregated), total wages, profits, and tax payments. Currently, this information is not computerized at the rayon or at the oblast level, but many officials thought this would be possible in conjunction with the new system of computerizing tax payment information. These reports usually remain with the rayon STS, but in some cases, they are passed up to the oblast STS.

The data are sometimes reformatted at the oblast and federal STS offices by sector or region. These data may be shared by the STS with the rayon government finance offices. The rayon finance office does not appear to receive the reports directly from enterprises.

More detailed information is sent by the enterprise to the oblast offices of the State Committee on Statistics (SCOS). The information comes into the SCOS on a monthly and an annual basis but it is not usually transferred in a computerized form by the enterprises. The data include the following: total profits, total exemptions, tax payments by type of tax, wages, output levels, total deductions and some information inter-enterprise transfers. These data are aggregated by sector at the oblast office and sent to the federal office in the aggregated form. Some of this transfer is made by computer. The federal office of the SCOS provides aggregate information to the MOF regarding enterprise profits, output, revenue, and expenditures.

Daily Monitoring of the Budget

There is some variation in the attention paid to the execution of the budget among rayons and oblasts. The Moscow oblast has a daily monitoring system where the finance officers input revenues and expenditures by type of receipt, and by department, on a daily basis. A simple computerized accounting program keeps a daily record of the budget balance. Other rayons and oblasts input data into a similar program on a weekly basis. Finally, some rayons monitor the budget (without the use of a computer) by hand-calculating entries in a ledger.

The MOF monitors receipts and expenditures on a monthly basis. They receive reports on revenue from the STS on a monthly basis. Expenditures are also reported on a monthly basis, with information transferred by the individual departments to the budget execution office. The MOF has no means to monitor the budget on a daily basis.

Wages

Historical information on wages is kept by the SCOS, and is derived from enterprise data. With the growing importance of self-employment, the committee admits that it will need additional information to correctly compute total wages. Wages are forecast by the MOE, largely based on government control of the minimum wage and the growth in industry and employment.

Socio-economic and Demographic Information

The storehouse of demographic and socio-economic data is the SCOS. Most of the data are collected at the oblast level, aggregated to some level, and sent to the federal office. The data transfer is not computerized, with the exception of a few oblast offices. The socio-economic and demographic data are collected based on annual surveys and a decennial census. The survey and census provide information regarding family size, age, total population, consumption habits, residence, type of employment, education, income, and additional payments.

As discussed above, the SCOS receives financial data from enterprises. They also receive detailed information on an annual basis regarding production, capital equipment and other holdings, and employment by occupation.

Summary of Problems and Ongoing Reform

There are a number of concerns at all levels of government concerning the flow and uses of fiscal information as well as daily fiscal management. The rayons and smaller oblasts have expressed frustration with classification of revenue and the monitoring of expenditures. In many cases, these governments do not have the computer resources and staff to develop a daily monitoring system of revenue and expenditures. Even in larger oblasts like Moscow Oblast, the finance directors do not have enough trained staff to input the data, so true analysis of revenue and expenditures is nearly impossible. More importantly, the data flow is often very slow and cumbersome. In some cases, the revenue collections data are not immediately turned over by the STS to the finance offices. This creates delays ranging from one day to more than a week. Expenditure requests must be made to the finance officers but in the larger governments, much

of the tracking of expenditures is done by separate departments. This has created a concern that actual expenditures could creep higher than budgeted expenditures during the year and the government would not know about this imbalance until much later.

Currently, the MOF can do a more efficient job of monitoring daily collections and expenditures, but they also have staffing and information flow problems. Again, revenue data flow from the STS but are not immediately shared with the MOF. Expenditures are also tracked by departments and aggregated by budget execution office.

The MOF is undertaking a rather significant fiscal management reform in the establishment of a federal Treasury. Its function will be to receive tax payments from enterprises in one lump sum for all governments, distribute the shares to local governments, and write the checks for federal expenditures. This will enhance the federal government's ability to track both revenue and expenditures on a daily basis. Local governments will be given the opportunity to contract with the federal Treasury to serve as the local treasury as well.

The preparation and flow of data, particularly from the STS to the finance offices of various governments is a concern at all levels of government. The STS is buried under paperwork associated with classifying tax payments and auditing enterprises. The hand-to-hand transfer of tax payment information on sheets of paper is overwhelming even for small offices. Under the current system, it is almost impossible to organize the tax data to produce summary information quickly or to use the tax data in a meaningful way for revenue forecasting and estimation.

There are two reforms underway in the country to begin dealing with the tax data problem. First, the IMF is running a pilot program in two rayons to develop a VAT declaration

form. The project is also developing the software to register enterprises and calculate taxes due, and to calculate under- or over-payment as well as penalties. At this time, the declaration forms have been developed and the computers and software are in the process of being installed. The project is being run with the STS in these rayons.

At the same time, the STS at the federal level has begun software development of its own. The software is used for enterprise registration and accounting of enterprise income and property tax. Currently, the software does not perform tax calculations, they are still done by hand. The software is largely used to generate a data base, containing basic information on the enterprise (address, contact person, taxes due and taxes paid). Various local STS offices are putting their own touches on the software or developing their own systems. One complaint heard a number of times was that the federal STS was too slow in developing and delivering the software and a lack of coordination made it difficult to use interactively. There is no central communications which would allow the local STS offices to transmit the data to the oblast or federal STS office. Most of this transfer is still done by individual offices, either in hard-copy or on diskette.

While summary budget information is vital to the country, there has been little in the way of reforming the collection and processing system. The office responsible for consolidation of the budget reports in the MOF does use a mainframe computer to process the information, but forms arrive from the local governments in hard copy form. This significantly slows down the processing of information. Additionally, this function of the MOF may change as the country adjusts to a new system of intergovernmental relations. If the MOF is not to be responsible for monitoring local budgets, it is important to have an annual system of reporting that is efficient for purposes of developing detailed annual report of the budgets of all levels of government.

The concern over the ability to estimate revenue and expenditures in times of tax law and responsibility changes has been addressed frequently by the Supreme and local soviets. The Supreme Soviet's budget committee has begun to develop a data base that allows them to estimate revenue under alternative tax laws and to forecast revenue with methods similar to those used by the MOF. The data base contains tax payment information, employment, wages, and macro-economic indicators, but all at an aggregate level. The ability to estimate revenues under alternative tax laws is done using aggregate data. The method allows "ball-park" estimates, but cannot disaggregate by region or sector. However, the Supreme Soviet feels that the ability to do such estimation is vital. At the local level, the Moscow Oblast Soviet is also developing the capability to estimate the revenue effects of changes in the revenue sharing rates and changes in the tax code. They currently use a software that enables an aggregation of total revenue collections in the oblast. A simple subroutine recalculates revenue when sharing rates are adjusted. The program cannot be used to estimate the changes to the tax bases, and can only roughly estimate the effect of a change in the basic tax rate.

While many government officials expressed interest in an integrated data base, there is little movement to develop such a system. The old system of collections by the SCOS is still in place, and there has not been a consolidated effort by the MOF or other finance offices to integrate the demographic data with their financial information.

SUMMARY OF ISSUES AND OPTIONS FOR TECHNICAL ASSISTANCE

There is significant potential for the development of an integrated data system to support a modern fiscal management information system. The data base and information system

development efforts are necessary for the improvement of the revenue and expenditure forecasting efforts, and to improve the general program of fiscal planning and management. The job will be made easier because the basic mechanism for information gathering is already in place.

The main users of such a data system would be fiscal analysts within the administration and within the Supreme Soviet. There has been a significant effort in the Supreme Soviet to establish such a unit and technical assistance would be well advised to start by thoroughly studying the information gathered and the models produced in that unit. Likewise, the MOF has made significant inroads in laying the groundwork for a full data system. Technical assistance would begin with a thorough review of the system of reporting and data collection now available.

There are two basic problems to overcome in establishing a useful fiscal information system. First, the current flow of necessary fiscal data is slow and it is transferred in a cumbersome way. For example, the STS does not have the capability to immediately inform the MOF or other levels of government as to their revenue position. The typical lag is two weeks to one month. Second, there is no daily monitoring of expenditures and revenue in the MOF. Some oblasts have developed this capability, but it is by no means widespread. Consolidated budgets and the federal budget are both monitored on a monthly basis, with information flowing from the banks to department heads to a separate budget analysis department. The current system makes it difficult for the MOF to know its financial position on any given day, and planning for emergencies is nearly impossible. The establishment of the new federal Treasury will help to

mitigate these problems in that a central office will be responsible for revenue and expenditure monitoring, but it will be useless without a coordinated effort in data collection and processing.

These two basic issues can be resolved with technical assistance from USAID. In addition, USAID may offer other forms of important technical assistance to the Russian Government. A plan of technical assistance in these areas is as follows:

1. Survey the rayon and oblast STS offices across the country for information regarding software and computerization. The regional STS offices are one of the more innovative groups in the area of computerization and the experiences in the offices of the Moscow Oblast and Lubersty Rayon suggest that other offices may be developing their own software. The survey should be conducted to determine: the existence of software to register enterprises and keep records of enterprises, to calculate tax liability, keep accounts of payments made, and for audit purposes. The survey should also determine the types of computers used and modern potential or use. This activity should be undertaken very early to establish the extent of technical assistance necessary to further develop these capabilities within the STS. The survey activity should be coordinated with the IMF project, as they have identified some of the software needs.

2. Upon completion of the survey, identify software and communications needs of the STS. Software development in the areas of declarations and payment processing is underway in the IMF project, but USAID might assist the development and distribution of the software. Software development is also needed for distribution of data from the rayon STS offices to the oblast and central STS offices. Beginning with pilot programs in one or two oblasts, USAID could develop communications software, provide necessary hardware (PCs and modems), and provide training to develop a database and transfer data from the rayon to the oblast and central STS office. The pilot program may be run in the two rayons involved in the IMF pilot, with one resident advisor for USAID to oversee the USAID component. Once software is developed, a short-term advisor should be sent to the central STS office to serve as the coordinator of the data collection effort. Specifically, the needs in this area are:

- Computerization of the tax payment recording process. This includes the development of communications between the banks receiving payments and the rayon STS office. Software would be developed in conjunction with the current IMF pilot project and the ongoing STS work. For purposes of the overall fiscal information project, this link could be extended to the finance offices of the rayons and oblasts, either directly through the banks, or more likely through the STS office.
- Development of uniform standards of reporting from the rayon to the oblast to the central STS office. There are reports currently used, but they are not computerized and in many cases, they are not uniform. Reports

should include: tax payment by type of tax and industrial sector for the period and year to date, over or underpayments, penalties, and type of tax payment (estimated or final). The specific design of the report should be made once an advisor determines the level of detail available in the rayon STS office on a monthly basis.

- Design, development and installation of software to collect, process and tabulate data according the specifications above. The design and development work could take place in the US, but should be done with input from the STS office at all levels of government. A short-term advisor should be assigned to the central STS office to install the software and provide technical support on its use.
- In the central STS office, further software development is necessary to produce an annual compilation of tax collections by type of tax, industrial sector and level of government. This software would process and collate monthly reports, update late payment information and produce a detailed report. The software would also allow transfer of the final report to the MOF and any other appropriate office.

3. An additional assistance project within the STS is the establishment of a sample of tax returns. Based on the on-going project with the IMF, the STS has developed declarations for the VAT, and there are plans to extend this work to other taxes. USAID can provide the assistance necessary to capture the enterprise tax returns into a database for use by the STS and the fiscal analysis unit of the MOF. This portion of the tax data project would develop the methodology and software to computerize tax return data at the rayon STS offices. The software would capture the major lines of the tax code, check simple calculations of deductions, exemptions, and tax liability, and update the data base. Using the software and communications developed in (2) above, the individual tax records would be sent to the oblast and central STS offices. At the central level, USAID could provide assistance in the computerization and maintenance of this large tax return base. A short-term advisor would assist in sampling techniques and the creation of a file for use by the MOF fiscal analysis unit and local government finance offices.

4. As a stand-alone project, USAID can begin technical assistance in the areas of revenue and expenditure forecasting and estimation immediately. To begin, a training course could be given in Moscow, with representatives from the MOF's likely fiscal analysis unit, pilot oblasts, STS and the Budget Committee of the Supreme Soviet. The training course would be a week long and cover topics including revenue and expenditure forecasting methods used in other countries, the impacts of central government policies on local governments, data needs, computer models, and some basic information on theoretical issues involved in forecasting (time series and trend analysis, forecast error). The purpose of the seminar would be to establish interest in the methodology and to lay the ground work for more intensive training in the MOF and local government finance offices and STS.

5. There should be a survey of the models and computerization used by finance offices and the soviets at the oblast and rayon level to determine the level of sophistication across the country. There is some variation across the country, and pilot projects may do well where innovation has begun. This survey could be conducted through the MOF which would provide a higher probability of response and accuracy of response.

6. Once the fiscal analysis unit has been defined, USAID can devote resources to the development of modeling and computerization of the unit. While the implementation of this activity would use data developed in the assistance discussed below, model development can begin at any time. The technical assistance would:

- Develop a revenue forecasting model for the MOF. This would include software development for forecasting the VAT, enterprise income tax, excise taxes, customs duties, and the individual income tax at the central level (total revenue in the country).
- Provide software that incorporates the ability to allocate revenue to the various levels of government. Software development need not be done in country, but should be done in conjunction with the establishment of the fiscal database and with analysts from the fiscal analysis unit.
- The second part of software development should be to develop revenue estimating capabilities. This would include changes in the tax code and sharing rates. The software should enable the analysts to determine the impact of changes on the distribution and level of federal taxes and local taxes, by region of the country.
- Expenditure forecasting software and methods should be developed in the same fiscal analysis unit. The software should have the capability to incorporate effects of changes in the expenditure responsibility at all levels of government.
- All software development should be done with input from the analysis unit responsible for providing the estimates. Once the software is developed, two short-term advisors should be sent to Russia, one for hardware support and one for software use support. In a three to five day seminar in Moscow, the advisors should present a documented demonstration of loading the software and running the models. This seminar should be done with individuals responsible for computer support in the fiscal analysis unit and pilot regional offices and a number of analysts from the same offices. A long-term advisor would then remain with the MOF fiscal analysis unit and provide support for use of the models over a six-month period. This advisor would also be responsible for sight visits and advise to the pilot regions.

7. USAID could provide instrumental assistance in the development of a fiscal information system, combining data from the MOF, STS, and SCOS. This would involve coordination among these offices, computerization of data and collection methods, and integration of a large quantity of data. This project could be broken down into three categories, each of which could be tackled separately by USAID. If the development of the system were taken on in total, a long-term advisor would be needed to coordinate the efforts of the STS, MOF and SCOS. The central office for the data base should be in the MOF or SCOS. If within the MOF, it could be located in the fiscal analysis unit, but would require its own staff, separate from the policy analysis staff. Short-term advisors would coordinate the work of each of the three crucial departments. The assistance could be broken down as follows:

- **Taxpayer return data (STS):** The technical assistance required in for this data has been described in (3) above.
- **Central and local budget data (MOF):** In conjunction with the Budget Execution Office of the MOF, the first priority is to establish the format of a detail report of budget execution information for the local and central governments. While this could be handled by a short-term advisor, if a long-term advisor were in place to assist with budgetary matters, this advisor could consult with the mission to develop such a report. This effort should be coordinated with the computer consulting firm FINTECH. The advisor should establish early contact with the firm. At a minimum, the report would contain actual spending by major department (health, education, housing, etc.) and capital expenditures by category, and revenue by source of tax and non-tax source, including subventions and subsidies. Software should be developed to produce the report in a uniform fashion (in coordination with the work on budgetary procedures, this software could also be developed to produce the report from uniform budget execution data held by the local governments). Finally, PCs and modem communication should be established in the pilot rayons and oblasts for data transfer from the rayon to the oblast to the central government. The long-term advisor would be responsible for developing the format of an annual report. The report should contain the detailed budget execution data developed in the uniform reports for the central government, oblast and rayons (sample of rayons), and the consolidated budget. The final report may be produced using the resources of FINTECH.
- **Socio-economic and demographic data:** The concentration of this data within the SCOS necessitates the inclusion of this Committee in the overall technical assistance project. While this Committee could use assistance in developing the level of their computerization, it is not the highest priority for this area of assistance. The advisor for the overall fiscal information project should inventory the time delays in the processing of data within the SCOS immediately. Based on this inventory, additional assistance

could be offered to the SCOS to develop the capability to collect and distribute the data in a timely manner. This may involve software development and computerization of data and data transfer. A short-term advisor would be required to coordinate the efforts of the SCOS once the needs have been detailed.

- **Coordination:** The long-term advisor would be responsible for coordinating the efforts of three short-term advisors. This person would also develop the software necessary for merging the data bases into a form useful to the MOF and local government analysis units.

8. USAID could provide assistance to the development of the new Treasury department within the MOF in conjunction with the plans of the IMF. The Treasury will be responsible for receiving tax payments from enterprises and individuals and making disbursements for all expenditures of the central government. The assistance that USAID could offer the Treasury is as follows:

- To fill the void in daily maintenance of the central budget, USAID could establish the necessary computerization of the Treasury and software to enable daily monitoring of the budget.
- A USAID long-term advisor should be assigned to the Treasury, and this advisor should begin their work by establishing the IMF's long-term support. In turn, the advisor could offer training for new Treasury officials, in coordination with IMF intentions.

9. If daily monitoring of the central budget can not be arranged through the Treasury, USAID can help to establish and train a new department within the Budget Execution Department of the MOF to monitor daily collections and expenditures. The assistance necessary would be identical to that in (8) above. At the local level, USAID could offer the following assistance for daily budget monitoring:

- Software development and training to establish a link between the local STS office (as noted in (2) above). This could be accomplished without an additional advisor, but rather with the assistance of the long-term advisor involved the STS computerization work.
- Computerization of expenditure execution. This activity includes software development to link the bank and finance office to immediately account for disbursements. If such a link is deemed not possible (due to banking rules or difficulties with computerization), the finance offices should be fitted with PCs and software that enables the finance office to update expenditures efficiently, and produce both detailed and summary reports

on a daily basis. The Moscow Oblast has begun some of this development on their own so they would an obvious pilot Oblast for this activity.

10. Much of the above work can only be implemented with well trained public sector employees. Training in the areas of public accounting, budgeting, fiscal analysis, and statistics is needed at all levels of government, but especially in the new fiscal analysis units and local finance departments. This training could take place in a series of seminars throughout the life of the project. In this way, broader assistance could be extended to areas in which no pilot project was available.

VII. PROPERTY TAXES

INTRODUCTION AND SUMMARY

The introduction of a legal basis for large-scale private ownership of land and buildings in the Russian Federation over the past three years has been accompanied by initiation of an annual tax upon real property holdings. In its current form the tax is both rudimentary and ineffective, in some (and perhaps most) cases incurring administrative costs greater than the revenue it generates. In the context of a newly instituted regime of private ownership, the establishment of the tax is itself a major achievement. However, its inequities and deficiencies must be addressed swiftly if it is not to fall victim to taxpayer confusion and evasion, and disregard by the very levels of local government that could most benefit from a property tax.

An effective property tax could serve two important functions. First, it could provide a revenue source under local government control, enhancing the autonomy and accountability of the level of government most directly responsible for property-related services. Second, it could establish an obligation for periodic payment as one element of private ownership in the context of a historic shift from state to private control of property. It is particularly appropriate to recognize a public claim to some portion of property's capitalized value at this time, when residential privatization requires only a nominal payment. Real estate is an inherently limited commodity, and one whose value draws upon social investment. Payment for its benefits, whether through rent, fees, charges or taxes, recognizes this status and can promote the most efficient utilization of property. The current economic turmoil in the Russian Federation,

however, necessitates that charges of this type be coordinated with the level of other taxes, the rate of inflation, housing subsidies, and similar relevant measures.

At present there are three major property taxes in the Russian Federation: a tax upon land, a tax upon buildings owned by individuals, and a tax upon buildings owned by corporations and other legal entities. This latter tax is part of a more general tax upon the balance-sheet value of corporate assets. The land tax is divided between the central and local governments, the tax upon buildings owned by individuals is retained by local governments, and the tax upon buildings owned by corporations is divided between the oblasts and local governments.

Revenues from these taxes are trivial at present, comprising less than 1 percent of consolidated government budgets in the Russian Federation. In some cases yields are so low that some local governments have reportedly refused to collect the tax at all. At the same time, privatization of housing and business property is proceeding at a rapid pace, often with only a small payment to the state. Although the tenant of a Moscow apartment who seeks to obtain ownership must complete many forms and obtain numerous signatures, the actual cash required may be as little as the equivalent of five U.S. dollars.

This situation presents both an unusual opportunity and a difficult challenge for the development of a new property tax system. The opportunity stems from the unique historical moment at which ownership rights are first transferred from the state to private parties. At this point there is the strongest possible equitable case for clarification of tax obligations, particularly when such transfers are for practical purposes nearly gratuitous. When ownership rights are first defined, initiation of a tax does not upset settled expectations or undermine contrary assumptions that may have guided buyers in bidding for property. This will no longer be the case when the

passage of time brings an increasing number of secondary real estate sales and development of an active public market for land and buildings. Moreover, lack of information concerning future tax liabilities is an impediment to large-scale privatization.

Institution of a local government tax is particularly appropriate at a time when basic local services are being curtailed for lack of revenue, when many of these services are property-related (such as road maintenance and sanitation), and when devolution of government responsibilities from the center to the localities has not been accompanied by any corresponding transfer of funding sources.

The critical challenge in fashioning such a tax is to coordinate it with larger economic, legal and fiscal developments in the Russian Federation. Citizens face "tax fatigue" induced by numerous new and sometimes overlapping levies at a time of rampant inflation. Privatization and the introduction of new taxes must proceed in tandem with wage policies, including housing subsidies, and macroeconomic efforts to control inflation. Because the concept of private property is so new to the Russian Federation, a comprehensive property tax requires clarification of many current uncertainties as to rights of ownership and many conflicting provisions in existing law.

At the same time, delay in introducing an effective property tax will cause its eventual imposition to upset economic expectations of property owners who did not anticipate such an obligation as an incident of ownership. Moreover, with or without outside assistance, it is clear that efforts will be made to impose some more functional form of property taxation, particularly in light of pressing local revenue needs. In the city of Moscow, the Bureau of Technical Inventory (BTI) has developed plans for a property tax under which it would evaluate and

register 800,000 apartment flats in the city. It estimates that introduction of such a tax would require expenditures of 15 million rubles, 8 million of which would be allocated for computerization, but that the tax could raise 1 billion rubles in 1993 alone.

A basic requisite for a more effective tax is a change in the tax base. Current payments are so nominal in part because the land tax is set in absolute terms (*e.g.*, kopecks per square meter) rather than as a percentage of market value. These amounts were initially set at low levels, and their fixed nature has meant that intervening inflation has left them negligible. The tax upon buildings owned by corporations is based upon balance-sheet value, with a maximum rate of 1 percent; the tax upon buildings owned by individuals is generally based upon cost figures unadjusted for recent inflation, with a tax rate of 0.1 percent. As a result, the average individual 1992 property tax bill in the Moscow oblast was less than ten rubles, an amount equivalent to one U.S. cent in June, 1993. Average individual property tax bills in the Odintsovo rayon for the same period were half that amount. A 50 square meter flat in the city of Moscow would incur a tax of about 300 rubles.

A change to an *ad valorem* basis is necessary if the tax is to serve as a source of revenue and an inducement to efficient land utilization. However, this will necessitate the assignment of accurate relative values to taxable properties. One legacy of decades of a centralized non-market economic system is an impressive inventory of physical characteristics of property with no corresponding information on market values. As secondary markets develop, this data will become available, but interim price estimates are extremely uncertain.

The BTI undertook a major building registration effort between 1969 and 1978, resulting in fifty books of documentation for property in industrial areas. New price indexes were issued

in 1984 and 1990. In 1992 a third index was issued, increasing previous price levels 25 times. Estimates show now that a 150-fold increase would be more accurate for Moscow, and a 236-fold increase is actually in effect in Leningrad.

The BTI building records, which are keyed to reproduction costs, may provide the basis for a rudimentary valuation system, possibly one employing broad "bands" of relative value such as are now being introduced in the United Kingdom. These records may also provide the basis for land value mapping without regard to structures and other improvements.

An effective property tax would be beneficial to local government and to land-use decisions. Revenue pressure alone can be expected to induce property tax reform; technical assistance will help this reform achieve its goals. The most important current areas in which such assistance is required are (1) in analyzing and comparing alternative tax bases to permit an informed policy decision among them; (2) in coordinating the tax with legal, economic and fiscal developments in the Russian Federation, and (3) in working with the BTI to update and computerize those records relevant to the tax as written.

PRACTICE OF PROPERTY TAX ADMINISTRATION IN RUSSIA

Sources of Information

Taxpayers are required (both by the land tax laws and the tax administration laws) to provide tax officials with information on their property, but these laws contain no penalties for non-compliance. (Moscow city independently imposes a fine for incorrect or missing data.) Inspection of business property is permitted and widely practiced.

Sources of information used in tax assessment include registers of deeds and titles, leases and other documents. Plots are registered by local technical inventory bureaus as well as by district and town committees on land reform and land resources. Land committees also have information on selling prices.

Valuation

Many different measures are used to set value, including a "normative price" of fifty times the applicable tax rate, auction prices, negotiated prices, and sale prices, with no invariant rules as to which measure will be used for any specific purpose. The normative price is generally used for evaluating shares in collective property, setting gift and inheritance taxes, and extending real estate loans. The normative price is subject to a lower limit, set in April, 1992, of 100 rubles per hectare. By Russian Federation presidential decree, the transfer price of land cannot be lower than its normative price. When selling land on a competitive basis local authorities are not allowed to increase the price of land more than 50 percent above its initial normative level. There are no restrictions upon the price of land sold by auction or through default on mortgages.

The BTI

The Bureau of Technical Inventory, or "BTI," was established in 1917 to assess immovable property. It is composed of 1,200 inventory committees with 25,000 workers. (It had 50,000 workers before the breakup of the USSR). In the city of Moscow the BTI has registered 80,000 buildings, including all residential structures, schools, public services, and some (few) enterprises.

The BTI has developed separate registration forms for residential and business structures. These list approximately 138 different items, including physical characteristics, legal ownership, and depreciation, although only a few of these entries are likely to be completed in the case of any specific property. (See the sample forms attached to this report.) These records deal with the property's physical attributes, and use those as the basis for a formulaic estimate of depreciated reproduction cost. They are not concerned with current market valuation.

BTI procedures call for a physical inspection of each property to take place once every five years. Data is compiled on inspection cards, compared to earlier records, and then entered into a computer, if the inventory committee has computer capacity. At present, records of 200 of the 1,200 inventory committees are computerized. There are 500 BTI inspectors in Moscow, with about 400 in the field every day. The background and training of BTI inspectors appears to vary widely. Officials in the Moscow office, themselves sophisticated and well educated, described their employees as expert professionals. However, rayon officials in Odintsovo strongly discouraged any contact with the local BTI office, describing its function as nothing more than rote computations based upon valuation formulas periodically updated by the central headquarters.

BTI also registers floor plans of buildings, and area surveys. Some of these are computer-generated. This type of detailed information is specific to Moscow, and is not collected throughout the country generally. There are no unified federation archives for the BTI; its records are dispersed throughout the 2,000 rayons, and are said to comprise twenty million pieces of paper.

The city of Moscow has set the goal of completing a building inventory in the next two to three years. The cost of completing the BTI registration for buildings to be privatized can be paid in part by enterprises and owners, who must confirm legal rights in their property before privatization proceed.

BTI does not market its services in a commercial manner, but as a self-financing municipal organization supports itself by charging for work as it is requested. It does not charge courts and legal institutions for its services, but will perform "commercial" valuations (for example, providing expert testimony in legal cases) for a fee. It has authority to set its own fees, and generally charges enterprises more than individuals. It charges about 500 rubles for registration in the case of privatization of an apartment, and about 1500 to 3000 rubles for the privatization of enterprise property.

Many buildings were not been properly registered in the past. The Pravda headquarters provides a dramatic example of the potential complexity of registering industrial property. This site was the equivalent of a small town, complete with factory buildings, canteens, shops, and housing, covering a total of 300,000 square meters. The city of Moscow contains 40,000 enterprises of various sizes, most of which have not been registered.

A major building registration effort took place between 1969 and 1978, resulting in fifty books of documentation for property in industrial areas. New price indexes were issued in 1984 and 1990. In 1992 a third index was issued, increasing previous price levels 25 times. Estimates show now that a 150-fold increase would be more accurate for Moscow, and a 236-fold increase is actually in effect in Leningrad. The oblasts and rayons have authority over adjustments of this type.

BTI has always been concerned with cost data rather than market value, although this cost data is indexed to reflect changes in current price levels over historical cost figures. It is particularly unwilling to begin to deal with valuation figures in the present inflationary situation. One example offered of price inflation over the past decade, even excluding 1992-1993, concerned cooperative housing valued at 80 rubles per square meter in the early 1980's, and ten years later at 3500 rubles per square meter.

The steps in the privatization of an apartment include: (1) an initial application and payment; (2) an application to the local building commission; (3) submission of further information and the signatures of all adult residents of the apartment; (4) application to the privatization committee; and (5) registration at the local building committee. Examples of some of these documents are attached to this report.

BTI does not collect data on actual market prices, but it does encounter information of this type in the course of its work. Commercial firms now collect this data, and a market in it can be expected to develop in the future, particularly in view of the increasing volume of resale transactions for privatized apartments in major cities such as Moscow.

A system of special committees and audit groups, with BTI participation, sets the price of nonresidential property transferred in privatization. These prices take supply and demand into account to some extent, but are by no means "market" prices. One example discussed at the Moscow City BTI concerned a folkloric theater, ownership of which was transferred to a performing group that would keep the theater in operation. Although another purchaser might have been able to afford a higher price, the committee felt that the value of continuing this use justified a price of 14 million rubles to the theatrical company. The unrestricted commercial

price was estimated to be 220 million rubles. Setting the price of some specialized properties (e.g., aviation industry structures) requires expert participation from other sectors. For example, the valuation of defense property is extremely specialized, but BTI has been called upon for help in estimating conversion values.

BTI estimates that introduction of a comprehensive residential property tax would require it to evaluate 800,000 flats in Moscow alone. As of March, 1993, there was a waiting list through August for BTI registration as part of the privatization process. BTI has developed a plan for establishing a property tax in Moscow that calls for expenditures of 15 million rubles, 8 million of which would be allocated for the introduction or improvement of computer systems. BTI estimates this tax could raise 1 billion rubles in 1993 alone. Although many observers stated that the city of Moscow had decided to postpone imposition of a property tax until 1994, the Moscow BTI was in fact preparing to send tax bills in 1993. A 50 square meter flat will pay tax of about 300 rubles. BTI officials expect that by 1994 families will pay about 25 percent of their income on total housing costs. Lack of information concerning future tax liabilities is one impediment to privatization.

The Moscow BTI has computers supplied by the Moscow government Institute of Computer Technology, which also provides it with ongoing computer support. The Moscow BTI can coordinate ownership data and physical property descriptions by computer and prepare tax bills electronically.

Entering paper data into its computers took 180 Moscow BTI employees working on 70 machines eighteen months. Entering floor plans will take ten years if they must be entered manually, five years if they can be scanned. At present Moscow BTI has only free-standing

computers (all have reached their data limit), but it has a goal of establishing a computer network in the future.

In part because it does not require government funds, BTI has excellent relations with other agencies, such as the Department of Municipal Housing, the Committee on Property, and the Construction Department, which all make use of BTI data. BTI officials expect to work more closely with the Tax Committee in the future.

Development of a Cadastre

An issue of great current interest and importance concerns the most effective method of recording land and building information. This discussion frequently centers upon development of a "cadastre," or official property register. Although this term is often used quite generally, it can refer to a register with any of a number of specialized functions, which need not be combined in a single set of records. A "legal cadastre" lists the title or ownership to land and buildings; a "fiscal cadastre" contains tax information, including valuations and assessments; a "physical cadastre" concerns parcel boundaries and building information. Because these functions are closely related to one another - as in the case of property taxation, which draws upon ownership records and parcel descriptions in setting valuation and assessments - the term "cadastre" generally refers to the combined set of records, an integrated or "master" cadastre.

Ministry of Finance officials expressed a common view when they stated that the current low rates of tax made it infeasible for the government to develop a comprehensive land inventory for tax purposes. However, a committee on a Moscow cadastre began work one year ago, with participation by BTI, Moscow Architecture (for open space), and the Moscow Geologic Trust.

This work has not included any consideration of issues of property rights and taxation. In the past, USSR cadastres were registers of the use and quality of agricultural land, forests and water resources, and were principally used for agricultural forecasts.

Development of a cadastre for the Russian Federation is proceeding in pilot projects with funding (and competing systems) from the IBRD, Sweden, Germany, Italy, Australia, and the Netherlands. The Swedish model is the most highly integrated, including information on taxation, land rights, structures and improvements, and mortgage loans. A Swedish model is being tested in Novgorod and in one rayon; the more decentralized German/Danish models have been introduced in St. Petersburg. The Danish firm was convinced to invest in the pilot project by the advertising value of its participation.

OPTIONS FOR REFORM

Clearly, current forms of property taxation are completely ineffective, both as a means of raising revenue and as an incentive for efficient land use. Any increase in tax rates must be approached with caution and an appreciation for the larger context of taxation and property rights. This should inform and not postpone property tax reform during this period of local government revenue stress and privatization.

Policymakers in the Russian Federation require assistance in analyzing the potential consequences of their options for property tax reform. Among these options are:

- an integrated tax upon land and buildings, or continuation of the present separate systems;**
- an integrated tax upon buildings held by individuals and by corporations, or continuation of the present separate systems;**

- a tax based upon property value, even if in a rudimentary fashion (*e.g.*, assignment of property to "bands" of value, or use of formulary cost-based values), or continuation of the current schedular system;
- if an *ad valorem* system is chosen, any of a range of goals for accuracy, equity and administrability;
- local control over tax bases or rates or continuation of the current centralized system (note the current *de facto* local control in disregard of legal limits upon land taxes; note also the apparently wide differences in data records and administrative capacity between the major cities and the smaller localities);
- determination of the role of the BTI and the State Tax Service in administering the tax.

The background against which these choices must be made include the current tumultuous economic, legal and fiscal developments in the Russian Federation. A number of government officials pointed to citizen "tax fatigue," citing a current total of 43 taxes (16 federal taxes, 4 taxes at the level of territories, oblasts, and autonomous republics, and 23 local taxes). They were of the opinion that establishment of a realistic property tax would necessitate a reduction in some other source of tax revenue. Some officials stated that taxes and fund payments now claim a total of approximately 48 percent of GDP: 33 percent for taxes (13 percent in direct taxes) and 15 percent in and payments to pension funds, road funds, price control funds, etc. The view was expressed that the nominal amounts of the present land and building taxes were not inappropriate in this regard.

Companies with zero taxable profits pose a similar dilemma. The property tax is not imposed upon a profits base; like rental payments to a landlord, tax payments to the government protect rights in property without regard to the profitability of business conducted there. At the same time, no government seeking to encourage new entrepreneurial ventures wishes to impose a new tax upon struggling enterprises without profits.

If coordinated with these larger economic factors, a property tax levied at more than nominal amounts could both support local government and encourage more efficient land utilization. A simplified valuation system could build upon the current approach of assigning formulaic values to land and structures according to a uniform classification of property attributes. This is particularly feasible in the case of land, where coordinated regional values could be developed on the basis of location and soil quality. Whatever the basis for the valuation, it needs to be made uniform if tax levels are to be significant. Current disparities between structures valued according to their BTI listings and those valued according to their compulsory insurance coverage, for example, would need to be eliminated.

The present division of immovable property taxes among agricultural land taxes, residential land taxes, business structure taxes and individual structure taxes requires close examination. If the property tax were to function as a significant revenue source, the sharp disparities among these would become far more important than at its present nominal level. For example, individually owned private housing is taxable, but housing owned by an enterprise is not taxable. The tax on individual property is a rudimentary real property tax, while the tax on business property is part of an asset levy based upon balance sheet values. While the most feasible initial steps might be harmonization of these separate taxes, careful consideration should be given to the political and economic implications of eventually merging them into a unitary system.

OPTIONS FOR TECHNICAL ASSISTANCE

A number of international aid organizations are currently assisting the Russian Federation in specific aspects of land administration, notably in development one or series of cadastres. The most important unmet needs identified in this report concern the larger underlying policy choices which should guide these administrative measures. It is critical to determine the basic direction of tax reform before investing scarce resources in administrative implementation. An initial choice among the options identified in the previous section requires clarification of the consequences of these many and extremely varied possible directions. This involves an array of choices, from the most basic decisions as to whether the tax base should include land and buildings, to the choice between a formulary or an ad valorem system and between various levels of precision in assigning values to specific properties. The current background of uncertain property rights, extremely high inflation and scarce administrative capacity present any property tax with serious practical, economic and political challenges. These choices themselves are political matters that supersede technical assistance, but such assistance can help supply the background necessary for informed decisions. The most important task for technical assistance is to allow these choices to be made with the benefit of as much relevant analysis as possible.

Once policymakers in the Russian Federation have made a decision as to the form of a property tax, many types of technical assistance will be useful, and some essential, for its successful implementation. The central initial step in any property tax reform will involve a shift from the current system of assigning tax liability to some type of an ad valorem basis - whether through very general formulas based upon property attributes, "bands" of value, or individual market-value assessments. The impressive data set already compiled by the BTI may provide

the basis for land-value mapping and a some form of simplified cost-based valuation of structures. Technical assistance, including data analysis, programming, and provision of computer capacity, will be essential in helping to utilize this data most effectively. The example of Moscow city BTI computerization shows the benefit that additional computer resources could offer local administrators. There, 270 person-years of effort has already been spent entering data into free-standing computers whose data capacity is now filled. Greater computer capacity could build upon this investment and help realize its potential.

Development of a comprehensive cadastre, either through an integrated register of physical, legal and fiscal data or through separate systems that can be coordinated with one another, raises complex issues. The numerous international assistance projects in this area may be somewhat incompatible and affected by the need to promote individual commercial systems. If that is the case, additional support would best be directed toward evaluation and coordination of the pilot projects now underway. As noted above, these include cadastre development programs with the IBRD and with firms in Sweden, Germany, Denmark Italy, Australia, and the Netherlands. In this situation, initiation of yet another program might offer far less assistance than a comparative analysis of the benefits and drawbacks of these existing systems in light of property tax developments.

The essentially voluntary nature of the current tax has precluded the development of compliance and enforcement efforts. Technical training in all aspects of property tax administration will be required for the transition to an operational tax system, as will development of legal procedures to deal with taxpayer protests and appeals. Such training will need to address a wide array of technical and managerial issues. Among these are data collection

and management, individual and mass appraisal techniques, billing and collection procedures, provision of taxpayer information and handling of appeals, and administrative issues such as planning, budgeting and personnel management.

Another element vital to an operational property tax is clarification of the legal background to property ownership and tax liability. The current ambiguities, contradictions, and inconsistencies found in the laws on property, ownership, privatization and taxation not only impede investment and market development but also prevent clear assignment of responsibility for payment of the tax. If tax bills were to rise to more than nominal levels, the present hybrid tax upon and upon use would need to be replaced by a more predictable and fixed system. Even under the current system it is clear that uncertainty has exerted some dampening effect upon residential privatization.

These elements of taxation require clarification of current property rights and greater consistency among the legal enactments concerning rights of ownership. Although this is an ambitious task that has implications far beyond the area of property taxation itself, substantive reform of property taxation requires a rationalization of property law.

Finally, as discussed above, steps toward implementation of a tax at more than nominal rates must be coordinated with larger economic developments, particularly in the control of inflation and allowance for housing subsidies. Assistance in understanding the relationship between specific tax proposals and this broader economic context will be critical to success of any tax reform efforts.

Moscow Oblast: 1992 Tax Revenue

	Thousands of Rubles	Percent of Total
VAT	1782927.60	54.96
Excises	266.40	0.01
Profits Tax	904105.30	27.87
Securities Transactions	7012.60	0.22
Personal Income Tax	470544.20	14.50
Natural Resources	2999.90	0.09
State Duty	8591.70	0.26
Property Tax - Enterprises	27470.30	0.85
Property Tax - Individuals	64.90	0.00
Privatization Revenues	4322.40	0.13
Agricultural Land Tax	1151.70	0.04
Non-Agricultural Land Tax	34844.20	1.07
Total	3244301.20	100.00

Source: Moscow Oblast, Department of Individual Taxation, March 22, 1993.