

@DECENTRALIZATION AND RECENTRALIZATION: RECENT DEVELOPMENTS IN RUSSIAN FISCAL FEDERALISM

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1. INTRODUCTION

This study represents the third and final report in a three-phase series of reports. In the first phase undertaken under the joint supervision of Professors Robin Boadway and Ronald Watts on behalf of the Institute of Intergovernmental Relations at Queen's University, four studies were undertaken on intergovernmental fiscal relations in Canada, the United States and Germany, the fourth being a comprehensive comparative overview of these three examples. In the second phase, a study of intergovernmental relations in eight further countries was undertaken. The resulting report covered two mature developed federations, Switzerland and Australia, four transitional federations, Brazil, India, South Africa and

Spain, and two decentralized unitary systems, Sweden and Japan. That report also included comparative references to the three mature federations covered in the earlier first phase. This current report represents the third and final phase of the project. It is a comparative review of the evolving institutional relationships within the Russian Federation, comparing these to the countries covered in the previous studies.

The previous reports identified both a number of common patterns and some significant variations among the various federations and decentralized unitary states. In all nine federations and two decentralized unitary systems, there has been a greater decentralization of expenditure responsibilities than of taxing powers. The former were relatively decentralized both for administrative efficiency and in the interests of subsidiarity and governmental accountability. On the other hand, revenues have been relatively more centralized in the interests of efficiency, of providing a base for redistribution among regional units, and of effective economic stabilization policy. The corollary of this situation has been the need in all these cases for substantial transfers by means of tax-revenue sharing and unconditional and conditional grants. There have, however, been variations in the degrees and extent of expenditure decentralization and of revenue centralization and hence in the size and composition of the transfers.

A second pattern common to every case has been the existence among constituent units of considerable horizontal disparities, and hence the establishment in all these cases (except the United States) of systematic equalization transfers. These too have, however, varied in form and scope.

A third common pattern has been the prominence of political factors in influencing the shape of intergovernmental financial arrangements. Despite the useful analyses of such economic theorists as Musgrave, Oates, McLure, Buchanan and Boadway, actual arrangements have been determined less by

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from the extra-budgetary funds transferred to the federated units. Indeed the latter have led to concerns about the extensiveness of soft budget constraints which affect the behaviour and efficiency of the federated units and the federal government.⁸ The phenomenon of extra-budgetary transfers and resulting soft budget constraints appears to have been substantially greater in the Russian Federation than in the eleven other federations and decentralized unitary systems to which it is being compared. Indeed, while much of the literature about financial arrangements in the Russian Federation tends to focus on the formal budgetary arrangements as adopted in the reform programs, at least one study suggests that there still remains in practice a much higher degree of informal subnational autonomy which stands in contrast to the centralizing character of the evolving formal system.⁹ But if this is so, it is extremely difficult to measure accurately for comparative purposes the significance of these informal processes.

3. THE POLITICAL CONTEXT

In our previous reports, we have noted the importance of the political context in shaping intergovernmental financial relations in federations and decentralized unitary systems. By contrast with those as a group, a noteworthy feature of the Russian Federation over the period 1992-2005 has been the fluidity of the evolving intergovernmental relationships and the frequent and almost continuous negotiation and adjustments to these. In general terms, we may distinguish four distinct periods.¹⁰ The first of these followed the dissolution of the Soviet Union in 1991, and spanned the period 1992-3. In a situation of acute economic crisis, lack of

federal regulation of the distribution of authority between institutions at various levels, and the proclaimed granting of sovereignty to the federated units of the Russian Federation, there was a strong polarization between the federal government and the constituent units. In this context regions lobbied hard for larger shares of tax revenue and transfers while the federal government pushed down expenditure responsibilities to the regional level. The actual division of tax authority between federal, regional and local governments mostly followed bilateral negotiations. These negotiations typically favoured more politically problematic regions. Expenditure assignments were particularly unclear and unstable. The Federative Agreement of 31 March, 1992, included neither uniform provisions on the distribution of authority and economic responsibilities between levels of government, nor the mechanisms for the realization of these responsibilities.

The Constitution of 1993 marked the beginning of the second phase in the political and financial evolution of the Russian Federation lasting up to 1998. The new

8. S. Selenikov-Murylev, P. Kadstchnikov, I. Trunin, S. Tchetenikov, "Budget Policies of Subnational Governments under Soft Budget Constraint," (Paper presented to Queen's University, Nov. 2004).

9. Aleksei Lavrov, J.M. Litwack, and D. Sutherland, "Fiscal Federalist Relations in Russia: A Case for Subnational Autonomy," Paris: OECD Centre for Co-Operation with Non-members, January 2001), pp.7-8.

10. I.V. Trounin, "Economic Reforms in the Early 1990s and Transition to New Principles of Federative Relations" (paper presented at Queen's University, Nov. 2004) combines the first two of these.

different arrangements with some 40 subjects of the federation, and 14 more were preparing such treaties, leaving only 35 which had neither concluded a bilateral treaty with the federal government nor were in the process of preparing one.¹¹ As a result, the intergovernmental financial arrangements had become arbitrary in character, depending heavily on the decisions of

a group: Spain with 49 percent, South Africa percent, and India with 55 percent, but more than Brazil with 36 percent.¹³ It is slightly more than Australia, the United States or Sweden, each with 46 percent, but substantially less than Japan with 62 percent, Germany and Canada with 63 percent and Switzerland with 68 percent.

with 50

But certain features of the Russian situation are particularly significant. While over the period since 1992 some order and standardization on expenditure assignments has eventually been achieved, and the current assignments now roughly resemble the expenditure responsibilities of federated entities in other federations, these measures have not yet been sufficient to guarantee a workable degree of clarity and stability in the allocation of expenditures.

To begin with, from the formal point of view, current legislation still leaves many expenditure assignments unclear. Even the new Budget Code allows for rather wide areas of ambiguous 'joint' financial responsibility. A substantial share of specific federal legislation and regulation does not specify which level of government bears responsibility, or state that this responsibility belongs simultaneously to both levels. As a result, regional and local levels of government end up financing a part of expenditures formally under federal responsibility (including various federal programs and utilities and rents for federal institutions), while the federal government has, on many occasions, at least implicitly taken on responsibility for subnational finance (for example, wage arrears).

Second, given the high degree of disparity in the wealth of different regions, the delegation of virtually all social expenditures to the regional ce (for cent Tc0

upon the transparency and accountability of

Thus, while in nominal statistical terms the level of regional expenditure in the Russian Federation is broadly comparable to that in many other federations, and particularly to the transitional ones, this assessment must take account of distinctive qualifications governing the exercise of the expenditure responsibilities of the federated entities in Russia. Instead, as a result, it would appear that in actuality the regional and local governments have had substantially less real discretion than the nominal 50 percent of combined expenditures would suggest. The federal government directly or indirectly has in reality had control over substantially more than 50 percent of the consolidated budget of the federation would suggest. The Russian Federation, therefore, has considerable distance yet to go to obtain the benefits of administrative efficiency and political accountability that have been achieved by the autonomy of decentralized expenditures in most other federations and decentralized unitary systems.

5. REVENUE CENTRALIZATION

It is in the allocation of control over revenues that the centralization of the financial arrangements in the Russian Federation becomes even clearer in comparative terms. Keeping in mind the definition of 'own-source' revenues referred to earlier in this report (and applied in the previous analyses of nine federations and two unitary systems), 'own-source' revenues of the regional units in 2000 amounted to a mere 17 percent. Of these, 11 percent constituted 'own-source' taxes and 6 percent 'own-source' non-tax revenue (see Tables 4 and 5). In the case of these 'own-source' taxes, the rates, tax bases and exemptions are set decentrally, but within a federal legal framework. The taxes within this category for regional budgets are: sales tax, property tax (enterprises), licenses and registration fees, and simple imputed income tax (personal). In the case of local governments the taxes within this category are municipal tax (up to 5 percent rate to the base of the profit tax, introduced in 2001), licenses and registration fees, property tax (persons), advertising tax,

regional governments for their expenditures. social infrastructure and other local taxes (mainly cancelled in 2000-2001).¹⁴

A further 57 percent of total regional revenues in 2000 came from shares of centrally regulated taxes, but because their bases and rates and sharing rules are totally or predominantly set by the federal government, they are more appropriately classed as transfers than as 'own-source' revenues of the regions.¹⁵

In comparative terms, the limited percentage of 'own-source' regional revenues is particularly striking. Only South Africa with a comparable figure of 3.9 percent is more centralized in the authority to regulate taxes.¹⁶ Moreover, as Table 3 indicates, in terms of 'own-source' revenues as a percent of total constituent unit revenues, the Russian Federation at 17 percent is substantially below that in all the other federations and unitary systems (except South Africa). In these other cases, 'own-source' revenues range among the transitional federations between 27 percent (Spain) and 60 percent (Brazil), and in the mature federations between 55 percent (Australia) and 80 percent (Canada). Thus, comparatively speaking, the federated units in Russia have remarkably less revenue autonomy, i.e. the ability to control and be accountable for the size of their revenues, than do the constituent units in other federations (except South Africa) and decentralized unitary systems. The regulation of taxes and revenues is clearly highly centralized within the Russian Federation with 91 percent of the combined revenues coming under central regulation.¹⁷

The control of regional borrowing should also be noted here. The period from 1992 until the crisis of mid-1998 witnessed a steady growth of borrowing, debt and loan guarantees at the regional and local levels of government. A federal law of 1993 had guaranteed regional and

14. OECD, Report 2002, op. cit., p. 163.

15. See Table 4; see also Kurlyandskaya, op. cit., Table 3.

16. See Table 1 and 3.

17. See Table 1.

constitutes more than the total of regional ‘own-shared revenues from federally regulated taxes, the Russian Federation follows a practice found in a number of federations elsewhere, notably Germany, Switzerland, Australia, India, Spain and South Africa, and also in Japan, but to a greater degree.¹⁹

source’ revenues. In relying so heavily upon

A lesser but not insignificant portion of transfers in Russia from the central government to the regional governments consists of the unconditional transfers for equalization of regional revenues (see further below under “Equalization”). As Table 5 indicates, in 2000 these were substantial, representing in aggregate 16 percent of total regional revenues. These unconditional grants when combined with shared revenues from taxes predominantly regulated by the federated government, represent a total of block transfers comprising 73 percent of total regional revenues. These contrast with the targeted conditional nature of the transfers in the third and fourth categories of transfers below which together in aggregate in 2000 constituted 9 percent of total regional revenues (see Table 5).

The third category of transfers are budgetary transfers targeted for specific purposes. By 2003 this category was comprised of several types of grants: Compensation Grants (funding of major federal mandates) which have been the largest in

At the same time, it should be noted that these decision-making processes have not been without some degree of interaction with representatives of the regional legislatures and administrative bodies. Such interaction has been essential for carrying out major reforms. Furthermore, changing the amounts of financial aid calculated and embodied in draft laws on the federal budget in Parliament has in practice involved a standing group consisting of interested representatives of the State Duma, Federation Council, the Government Administration of the President of the Russian Federation and various ministries and departments. This has meant that the proposals of the Ministry of Finance have been approved by the Federation Council more easily and without considerable changes.²⁸ But then, as noted in our previous report, even in such decentralized unitary systems as those in Sweden and Japan, where it is central legislation which determines the overall pattern of devolution in the financial arrangements, regional and local interests have been regularly consulted and have had considerable influence upon the decisions that have resulted.²⁹

mandates, and from the failure as yet to eliminate practices creating soft budget regional expenditures. Thus, the Russian Federation has yet to achieve the full potential economic efficiency that could be obtained from decentralized expenditures.

2. Equity

Here too recent reforms in Russia to the equalization arrangements have exhibited significant progress, particularly in methodology. But continued sharp regional financial disparities and the degree of poverty in certain regions remain a key problem, as witnessed by continuing disturbing trends in some demographic and health statistics. Since most of the responsibility for social expenditures currently rests with the regional and local governments, equalization of their revenues occupies a particularly important role in achieving inter-regional equity. A negative factor has been the reallocation under recent reforms of a significant amount of revenue from the regions to the federal government, imposing constraints generally upon regional efforts to finance social expenditures. The previous *OECD Economic Survey of 1999-2000* recommended a much greater federal responsibility for financing social policy, particularly in support of the poorer segments of the population. The long-term economic program of the federal government has been consistent with this recommendation, proposing a reallocation of state investment funds towards social policy. But other than the creation of a new transfer fund to back some federal mandates with financing, this reallocation has yet to be realized. In comparative terms, because the inter-regional disparities have, to begin with, been so much larger than in the mature federations and indeed some of the transitional federations, correcting these has been much more difficult. The Russian Federation is still a long way from achieving the reduction of disparities achieved by the most successful federations in this regard, Australia and Germany.

3. Fiscal management and stabilization policy

The concentration of central control over taxing powers in Russia has in general facilitated

constraints upon

the central management of the economy and of stabilization policies. In recent years the Russian government and the Central Bank have maintained responsible macroeconomic policies, exercising the financial restraint necessary for stabilizing expectations, normalizing relations with foreign creditors and improving the credibility of fiscal and monetary policy commitments. The Russian authorities quickly succeeded in restoring at least some degree of macroeconomic stability in the immediate aftermath of the crisis in 1998. Since then fiscal and monetary policy has received an important boost from the subsequent strengthening of oil and gas prices on world markets.

Even though the federal government took a decision in 2001 to resume servicing foreign debt in full, it has continued to maintain a tight fiscal policy, not allowing federal expenditures to increase along with significantly higher tax revenues. Given the uncertainty over oil prices and exceptionally high foreign debt repayments due in 2003, the Russian government came under some pressure to generate surpluses. Consequently, in 2001 it created an implicit 'stabilization fund', committing itself to surpluses in 2001 and 2002. With a strong dependence of the federal budget on oil and gas prices this type of stabilization fund made good sense, paralleling funds of this nature created in a number of other countries facing fiscal risks from commodity price fluctuations.

4. Autonomy of constituent units

Since the essence of federations is the combination of 'shared rule' for certain purposes (through the common institutions of a federal government) with 'regional self-rule' for other purposes (through autonomous governments of the constituent units), a significant political criterion is the degree of autonomy of the

ability of the constituent units to control and hence the scale of the expenditures. The second relates to the degree of expenditure discretion that they are able to exercise within the revenues that are available to them.

In terms of revenue autonomy, the highly centralized regulation of taxing powers that we have already noted, which is considerably more centralized than all but South Africa among federations and even decentralized unitary systems, means that the subjects of the federation have in comparative terms very restricted revenue autonomy. When we turn to the issue of expenditure autonomy, within the inflexibility of the revenue levels largely imposed upon them, the relatively large proportions of their total revenues consisting of unconditional revenue sharing or grants (73 percent of total constituent unit revenues)³¹ means that the regional governments would appear to have considerable expenditure autonomy. Indeed, the total of conditional transfers as a percent of total regional revenues is 9 percent, placing the Russian regional governments among those constituent units in other federations and decentralized unitary systems that have lesser constraints on their discretionary expenditure.

This assessment of expenditure autonomy for the constituent units in the Russian Federation has to be qualified, however. In the section on expenditure decentralization we have already noted the impact of a number of factors affecting the expenditure autonomy of the constituent units. Among these have been continued ambiguities concerning areas of 'joint' financial responsibility, the constraints upon regions with more limited resources, the impact of continued unfunded federal mandates, and the uncertainty engendered by practices resulting in soft-budget constraints. Furthermore, to this have to be added the recent assertion of presidential controls over regional administrations through the appointment, instead of the election, of regional governors. The result is in practice a considerably higher degree of federal regulation over the expenditures of the

accountable for the size of their revenues and federated entities than found in most other federations. Indeed, it is more akin to that found in the decentralized unitary systems.

Nevertheless, despite the recent measures aimed at increasing federal control, the situation should not be exaggerated. In terms of expenditure autonomy, subnational administrations in the Russian Federation do possess considerable means for conducting their own policies, and there remains a significant degree of expenditure autonomy which stands in contrast with their extremely limited degree of revenue autonomy.

5. Coordination and degree of central influence upon constituent units

The analysis in the preceding sub-section indicates that currently through its regulation of most revenue sources and the constraints it can impose on regional expenditures, the central government is in a position to exercise considerable coordination and influence over the regional and local governments. In comparative terms this clearly contrasts with most other federations, and particularly the more decentralized ones like Switzerland and Canada. But, of course, this has been achieved in the Russian Federation by sacrificing the degree of regional autonomy found in most other federations.

6. Transparency and accountability

The heavy reliance upon a large variety of intergovernmental transfers and the almost constant shifting and changing of these arrangements has placed severe limits upon their democratic transparency. The financial arrangements are complicated and difficult enough for specialist scholars to interpret and understand, and so it is not surprising that they lack transparency for politicians and electors within the system. This has seriously weakened the democratic control of decision-making.

Similarly, the often ambiguous relative roles of governments, the complex nature of the financial arrangements and calculations, and the

31. See Table 5.

heavy reliance of regional governments upon have seriously limited their political accountability. Where regional governments do not control the source and size of much of their revenues, it is difficult to hold them accountable. Thus, the principle that governmental responsibility and accountability for expenditures is best achieved when they have themselves to raise the taxes and revenues to cover those expenditures, is to a large extent missing. In those federations where regional governments typically rely on a much higher proportion of own-source revenues than in Russia, democratic accountability has tended to be clearer, although even in those cases, the use of considerable intergovernmental transfers has moderated this accountability.

7. Political stability and adaptability:

Political stability and flexibility may appear to be contradictory criteria, but both are essential for the effective operation of federations. Political stability relates to the extent to which the processes of intergovernmental financial relations are carried out with a minimum of conflict and have a stabilizing influence upon the operation and development of the country. Clearly political stability is an important objective for a federation to remain sustainable. But conditions change over time and the ability of the fiscal arrangements to assist the federation or decentralized unitary system to respond to these and to adapt over time to changing circumstances is also an important objective. Taken together, these criteria mean that adaptability should be sought but without destabilizing the polity.

In the period since 1992, the financial arrangements within the Russian Federation have certainly proved flexible, undergoing virtually constant change. The financial arrangements have fluctuated from the decentralizing and asymmetrical relations of the Yeltsin period to the current more uniform and highly centralized arrangements. Many of these fluctuations and frequent reforms were, of course, necessary to respond to clear crises. But, by comparison with the other federations and decentralized unitary systems analysed in our previous reports, the Russian Federation stands

transfers rather than their 'own source' revenues out as having been marked by far less stability in its financial arrangements. It may be that as the recent reforms are refined, a greater stability will come into effect. But the recent introduction of new arrangements directed at recentralizing authority and strengthening what President Putin calls the "vertical of power" suggests that intergovernmental relations within the Russian Federation have not yet achieved a stable equilibrium.

8. The relative significance of institutions and political culture:

In assessing the operation of federations and decentralized unitary systems in our previous studies we have noted that the prevailing political culture has been as important in shaping their development as the particular structure and character of their institutions. Indeed, their effectiveness has depended as much on the widespread public acceptance within them of the basic values required for federal systems: the explicit recognition and accommodation of multiple identities and loyalties within an overarching sense of shared purposes and objectives, the cherishing of diversity and an emphasis upon tolerance and accommodation, respect for the rule of law and constitutional legality, and the realization that compromise is not a weakness but a strength.

Given the path-dependency of the development of the Russian Federation out of the preceding Soviet institutions, the fluidity of the evolution since, and the recent perceived necessity to re-assert centralized authority in order to hold the federation together, it is not yet clear whether a federal political culture has firmly taken root or is still awaiting development behind a thin veneer of formally federal institutional structures. If experience elsewhere is any guide, the long-term effectiveness of the intergovernmental financial arrangements will depend heavily on the extent to which the prevailing political culture evolves to support these arrangements.

10. CONCLUSIONS

United States	67	54
Germany	65	37
Canada	44	37
Switzerland	40	32
<i>Transitional Federations:</i>		
Spain	83	51
South Africa	95	50

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TABLE 2: COMPARATIVE REGIONAL AND LOCAL GOVERNMENT SHARES OF TOTAL (ALL GOVERNMENTS) REVENUES AND EXPENDITURES¹

Country	Percent of Total all Governments Revenue	Percent of Total all Governments Expenditure	Vertical Gap ²
<i>Russia:</i>	9	54	45
<i>Mature Federations:</i>			
Australia	31	46	15
United States	33	46	13
Germany	35	63	27
Canada	56	63	7
Switzerland	60	68	8
<i>Transitional Federations:</i>			
Spain	17	49	32
South Africa	5	50	45
Brazil	31	36	5
India	34	55	21
<i>Mature Unitary Systems:</i>			
Japan	42	62	20
Sweden	43	46	3

1. Revenue Shares are before transfers of shares of taxes regulated by the central government and grants to regional and local governments. Expenditure shares are after transfers of shares of taxes regulated by central government and grants to regional and local governments. Figures are rounded to the nearest percent. Countries in each category are listed broadly in ascending order of decentralization. Depending on source figures are for 2000 or 2001; Russian figures are for 2000.
2. Vertical gaps are identified by difference between total regional and local expenditures and total regional and local own-source revenues (before transfers of shares of central taxes and grants).

Source: As for Table 1. See also Table 6.

TABLE 3: COMPARATIVE CENTRAL TRANSFERS AS PERCENT OF

TOTAL CONSTITUENT UNIT REVENUES¹

Country	Own-Source Revenues	Total Transfers ²	Conditional Transfers
<i>Russia:</i>	17.0	83.0	9.0
<i>Mature Federations:</i>			
Australia	54.7	45.3	21.3
United States	70.4	29.6	29.6
Germany	56.2	43.6	9.8
Canada	80.2	19.8	15.8 ³
Switzerland	75.2	24.8	17.0
<i>Transitional Federations:</i>			
Spain	27.2	72.8	41.9
South Africa	3.9	96.1	11.0
Brazil	60.0	30.0	7.5
India	54.0	46.0	18.7
<i>Mature Unitary Systems</i>			
Japan	62.8	37.2	16.2
Sweden	84.2	15.8	4.4

1. Figures are mostly for 2000 and 2001 except for those for Canada, United States and Germany, which are for 1995 or 1996 (derived from previous studies for this project).
2. Total transfers consist of shares of taxes regulated by central government plus unconditional and conditional grants.
3. If CHST transfers which are semi-conditional are considered unconditional, the percentage for Canada would be 0.9%.

Sources: R. L. Watts, *Intergovernmental Financial Relationships in Eight Countries: Final Report* (Reform of Fiscal Federalism in Russia Project, Institute of Intergovernmental Relations, Queen's University (April 2004), Tables 2, 3, 4. See also sources for Table 1.

TABLE 4: COMPOSITION OF REGIONAL AND LOCAL BUDGETARY REVENUE IN THE RUSSIAN FEDERATION IN PERCENT

	1998		1999		2000	
	Regional	Local	Regional	Local	Regional	Local
Total revenues	100	100	100	100	100	100
<i>of which:</i>						
A. Shared Taxes	50	52	60	56	57	53
<i>Regulated</i> ¹	30	38	25	42	22	39
<i>(of which: profit tax)</i>	-	(10)	-	(17)	-	(14)
<i>Fixed federal</i> ²	3	12	4	12	4	12
<i>Subject to federal Ceiling</i> ³	17	2	31	2	31	2
<i>(of which: profit tax)</i>	(15)	-	(20)	-	(21)	-
B. Own-source taxes ⁴	14	12	15	15	11	14
C. Non-tax revenue	6	4	6	4	6	3
D. Transfers from higher-level budgets and extra-budgetary funds	30	32	19	25	25	30

1. Rates and sharing rules are set annually by the superior level of government.
 - a) For regional budgets: VAT, personal income tax, excises, and tax for natural resources (except payments for natural deposits and land tax).
 - b) For local budgets: VAT, personal income tax, profit tax, single imputed income taxes, and taxes for natural resources (except payments for natural deposits and land tax).
2. Rates are set entirely by the superior level of government and sharing rules fixed by federal legislation.
 - a) For regional budgets – payments for natural deposits.
 - b) For local budgets – payment for natural deposits

TABLE 5: COMPOSITION OF TRANSFERS TO REGIONAL GOVERNMENTS IN RUSSIAN FEDERATION, 2000, IN PERCENT OF TOTAL REVENUES

Total Regional Revenues:	100 %
1. Own-Source Revenues:	
Taxes	11

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