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Budget System Reform in Transitional Economies: The Experience of Russia

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Abstract

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This paper stresses the role of budget system reform in economies in transition as an essential basis for the implementation of effective fiscal policies. However, introducing such structural reforms in often unstable economic environments has not proved easy. Using Russia as a case study, the magnitude of the problems faced is documented, and the strategy of reform eventually adopted is critically reviewed. In conclusion, some lessons are drawn for other transitional countries undertaking similar reforms, and the future agenda for completing these reforms in Russia is indicated.

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Contents	Page
I. The Role of Budget System Reform in Economies in Transition.....	3
II. Reforming Budget Management in a Crisis Environment.....	4
III. The Need for a Longer-Run Strategy for Budget System Reform.....	5
IV. External Constraints on Reforming Budget Management.....	6
V. The Need to Improve Existing Budget Management Procedures.....	8
VI. The Strategy of Improvement: an Overview of Reform in the 1990s.....	11
VII. The Remaining Areas for Reform.....	18
VIII. Lessons From the Russian Experience	21
Text Tables	
1. More Realistic Budget Estimates	14
2. Control Over the Payment Process.....	15
3. Restructure the Accounting System to Form the Basis of a Financial Information.....	16
4. Develop Financial Management and Planning Functions	17
References	24

I. THE ROLE OF BUDGET SYSTEM REFORM IN ECONOMIES IN TRANSITION

Realistic and accurate budget planning and execution are central to effective fiscal policy, and require not just administrative capacity within government but also a budget system which determines the procedures to plan, control, and monitor spending effectively. The importance of institutional arrangements for the implementation and sustainability of fiscal policy has been increasingly emphasized.² Recent literature on fiscal decentralization has indicated that fiscal consolidation may be more difficult to attain in a setting with uncoordinated decentralization.³ Many studies have also indicated the importance for fiscal discipline of the constraints imposed by fiscal rules and by other constraints imposed by the legislature,⁴ and similarly, the importance of administrative arrangements for translating fiscal policy into action has been stressed.⁵

Concurrently with this recognition of the influence of institutions on policy, there has also been the realization that the structural transformation of economies in transition involves more than liberalizing economic policies, but also in building the institutional capacity for implementing these policies. The growing literature analyzing transition experiences has stressed that such fundamental economic reform entails a process of change that is heavily influenced by a country's underlying institutional structure and its ability to change that structure. Transformation from a planned to a market economy requires drastic changes in behavior in all economic agents—but most especially the government sector. The essential characteristic of a planned economy is that the government is the major allocator and user of resources through a planning mechanism and associated passive financing by the budget system. The transition process requires, among others, that planning processes be replaced by market mechanisms, and this, in turn, necessitates transforming the budget system to one more compatible with a market economy. In this way, the reform of the budget system is critical in ensuring that the behavior of the government sector reinforces the transition process and increases its credibility and sustainability—in actively determining goals of public policy, and in ensuring and verifying that these are achieved.

² Williamson, 1993; Holtham and Kay, 1995; Hausman and Stein, 1997.

³ Ter-Minassian and Craig, 1997.

⁴ Von Hagen and Horden, 1996; Potarba, 1996.

⁵ This work in fiscal policy parallels another widely studied area—the degree of independence of the Central Bank and its implications for monetary policy targets (Masciandro and Tebellini (1991), Cukierman, Neyapti and Webb (1992), Alesina and Summers (1993)).

As utilized here, the term “budget system” is interpreted broadly to encompass the legal, institutional framework as well as the administrative procedures that determine the means whereby resources are transferred to the government, how the use of these resources is prioritized and directed to agreed policy objectives, and then subsequently managed, controlled, monitored, and reported on. Perhaps this very breadth is an explanation of why the process of budget system reform has not proved easy—indeed for many of the transitional economies, after over a decade in transition, the process is yet to be completed. Why has progress been so slow? Why has this type of institutional change proved so difficult to engineer? Why has this structural reform typically lagged behind those in other areas, for example, in restructuring the role of the central bank and the banking system?

In attempting to answer such questions from the experience of Russia, this paper begins by examining the forces that shaped the scope for reforming budgetary practices during the initial transition period—a period of pronounced fiscal stress, which certainly curtailed the reform options available. Other constraints on reform were external factors, outside the budget system, arising from the institutional and procedural legacy of the planning system. The weaknesses in the Russian budget system inherited from the Soviet era meant that any solution would take time. Certain key areas in budget management required radical restructuring, and in other areas new functions required to be created. Against these weaknesses, the strategy of reform in the 1990s, leading to the adoption of a new budget system law, the Budget Code, in 2000, is described, and the level of success in improving various aspects of budget management is then assessed. Finally, a retrospective assessment of the Russian experience is offered to highlight key lessons learned from Russian efforts in reforming its budget system in the transition period, which may be of more general applicability.

II. REFORMING BUDGET MANAGEMENT IN A CRISIS ENVIRONMENT

The ultimate objective of reforming budget management is to create a budget system able to perform the three main functions of a modern budget system: first, to ensure control over expenditures so that they are consistent with the budget law; second, to stabilize the economy through timely and efficient adjustment in fiscal aggregates; and third, to promote efficiency in service delivery through procedures that provide incentives for greater productivity.

The budget system that Russia inherited from the Soviet Union focused mainly on the task of ensuring compliance with government-endorsed expenditure plans and enabling laws and decrees. Even from this perspective, budgetary controls were less than complete and relied on controls derived from other parts of a highly controlled political system. The tasks of ensuring macroeconomic stability and efficiency were viewed as the prime responsibility of the centralized planning process, which aimed to ensure overall balance in the economy, and that resources were employed in such a way as to maximize society’s development objectives, as defined in the national plan. In meeting these objectives, the budget system only played a supporting role. The fiscal imbalances and blatant inefficiencies in production that ultimately became evident toward the end of the Soviet era made clear that the planning system could not meet sustainable stabilization and efficiency objectives. This failure, and the consequent economic crisis created, led to increasing recognition of the need to reform budget management

procedures. Ironically, at the same time, it could be argued that the crisis environment that was engendered also made the task of budget system reform much more difficult. This lack of room to maneuver in a highly unstable environment quickly revealed the weaknesses of an incremental budget system geared to operating within a system of administered prices.

III. THE NEED FOR A LONGER-RUN STRATEGY FOR BUDGET SYSTEM REFORM

From the perspective of longer-term budget system reform, the degree of fiscal stress encountered in Russia and other former Soviet Union (FSU) countries made the implementation of reform more difficult. Fiscal policy during the initial transition period, which should have been designed to complement structural changes in the economy, was directed to supporting old institutional structures—e.g., by providing financial support to inefficient enterprises. This reaction to the fiscal difficulties that were being encountered hindered complementary reforms in the underlying budget system, required for the move to a market-based economy. As indicated previously, budgetary management had to be reoriented from ensuring compliance with agreed budgetary allocations to ensuring overall balance in the economy and efficiency in resource allocation. However, preoccupations with immediate problems of fiscal stress, the need to accommodate vested interests, and the opportunities for rent seeking jeopardized the possibility of attaining this reorientation.

More narrowly, in terms of budget management procedures, the urgency in dealing with fiscal stress also resulted in an overemphasis on short-run solutions, diverting attention away from long-term solutions. For example, initially, a typical short-run approach was to match spending allocations to short-run resource availability. However, the only administrative mechanisms available to cut expenditures were controls over cash releases without fundamental policy changes and cuts in commitments, this cash-based adjustment proved to be disruptive in the short run, and its persistence jeopardized desirable long-run improvements to budgetary procedures.

Experience showed that the imposition of cash limits was no substitute for policy adjustment that would allow commitments to be restrained. Without the latter, cash controls tended only to delay spending and/or create arrears to the rest of the economy. Throughout the 1990s, Russia was plagued by a substantial domestic arrears problem. Moreover, the social pressure to exempt politically sensitive and large items of spending from the cash limits implied that the impact of cuts were more severe on the other categories of spending. In particular, operations and maintenance spending suffered, and delays in capital spending resulted in a substantial number of partly completed and abandoned projects.

The degree of inefficiency in government resource allocations was severe. Focusing on cuts in items of spending rather than cutting programs and activities undoubtedly added to inefficient resource allocation. Indiscriminate across-the-board cuts in materials were most disruptive to all types of service delivery. The problem was heightened by the fact that cash limits usually were imposed at short notice from the center, without the involvement of spending ministries. Not only did this add considerably to the problems of budget managers trying to minimize the

disruption to orderly resource allocation, but also, at the same time, it considerably added to the uncertainty of future resource availability.

Obviously, if carefully engineered, short-run and longer-run improvements to the budget system need not be incompatible. While fiscal crisis may have been a barrier to reform, it could also have been an opportunity to introduce fundamental reforms. It has been argued that in crisis conditions changes may be more easily accepted and more quickly implemented. However, faced by important vested interests, there was only a slowly growing recognition that the long-run solution to some of the worse aspects of fiscal stress lay in undertaking budgetary reforms that would allow the budget to become a tool to stabilize the economy (rather than a destabilizer) and give it the flexibility to adapt more successfully to rapidly changing circumstances. The initial reaction was to attempt to muddle through. Moreover, many of the short-term solutions previously described did not promote a healthy environment for reform, nor did they encourage increasing flexibility that would allow a more rapid and orderly response to resource shortfalls. There was an obvious need for a long-run strategy of budget reform that should run parallel with, and allow the integration of the short-term demands of crisis management.

IV. EXTERNAL CONSTRAINTS ON REFORMING BUDGET MANAGEMENT

Any long-term strategy for reform in the fiscal area had to come to terms with rapid changes in all spheres of life experienced in the FSU. Certainly, when dealing with the budgetary process in FSU countries, it was impossible not to be aware that this was an evolving system. This was evidenced by rapidly changing administrative structures, characterized by a fragmentation of functions as redundant institutions were replaced on a piecemeal basis with new institutions more relevant to a market-based economic structure. This process led to a lack of clarity in key areas of the budget process, both with regard to responsibilities and the procedures employed. A number of factors can be identified as contributing to this uncertainty, and having a direct impact on the budget process, are discussed below.

The emerging view of the state's role in economic activity

Initially, the major part of economic activity lay in the public domain, with an unsettled political consensus on what should remain public and what should form the basis of a nascent private sector. Underlying the difficulty in defining the role of the state was a system where functions were intermingled and the budgetary sphere of activity remained undefined. Large enterprises undertook functions that would be considered budgetary in nature (e.g., maintenance of schools, clinics, daycare, and retirement centers; and the provision of basic infrastructure), whereas budgetary institutions often carried out functions that were potentially of a private nature (e.g., some large ministries were often no more than holding companies for enterprises, and large ministries, like Defense, had numerous enterprises in their portfolios). Even today, this commingling of functions survives in lower levels of government.

The changing power balance between the legislature and the executive

Perhaps, not surprisingly, when moving from a situation where the Communist Party controlled both the legislature and the executive branches, in the new constitutional environment the two branches have had to find a *modus vivendi* in various areas, including budget issues. The resulting tension has been one of the factors that stimulated the number and importance of extrabudgetary funds and quasi-fiscal operations, outside the budget and the control of the MOF. On a general level, this had important implications for the ability of the MOF to formulate and implement fiscal policy. More specifically, it often created frictions between the MOF and the emerging Central Bank, which was granted independence from the executive, answering to the legislative branch.

The evolving balance between the central government and the subordinate levels of government

This balance has fluctuated over the decade. First, there was a move to decentralization and a consequent imbalance in distributing the burden of government spending relative to receipts. The initial result was growing deficits at the federal level and increasing surpluses at the local levels. This vertical imbalance in the public finances was subsequently reversed by the center assigning more unfunded functions to the lower-level governments.⁶ Although by end-1999, on average, federal transfers only accounted for about 15 percent of subnational revenues, they were of critical importance for a majority of regions and localities.

Budget legislation evolved alongside this process, trying to impose some order on a rather chaotic situation. The net result has been an open contradiction. In theory, the regions should be under the control of the federal government. Federal laws determine the majority of revenue and expenditure obligations—the federal Tax Ministry collects all taxes and then allocates them to various budgets. All main tax rates and tax-sharing rules are determined in the federal Budget Law. However, in practice, the lower levels of government were able to circumvent these controls, in ways that undermined budget processes.

The realigning of finance and planning

From being the prime allocator of resources in the economy through its power in determining the state plan, the ministry in charge of the economy (typically the successor of the State Planning Ministry, Gosplan) was forced to take a subsidiary role in this process. In Russia, as in many republics, though still nominally in charge of macroeconomic planning, the new Ministry of Economy (MOE) found this task increasingly difficult in an uncertain and volatile environment. Although it managed to retain its authority to determine investments, this was also of diminished importance with the decline in resources available for investment. On the other

⁶ This paper does not deal with the fiscal federalism aspects of the Russian budget system. This is a wide topic and the subject of intensive study elsewhere (Wallich 1994; OECD 2000; Lavrov et al., 2000).

hand, the MOF, from its former role as a support function of the planning process, emerged as the prime allocator of resources in the economy through the budget. Although ill-prepared and, initially, in the absence of developed monetary instruments, the MOF also had to assume the role of the principal macroeconomic manager.

The changes in the relative importance of different departments within the MOF

In a stable planning environment, the Budget Department, responsible for preparing the budget, derived its importance from determining financing flows to facilitate the plan's implementation. However, in the turbulent macroeconomic conditions experienced in the early stages of the transition process, the budget's role as a resource allocation mechanism was downgraded in importance and its role in securing greater macroeconomic stability was increased. Moreover, the lack of political consensus and the volatility in economic conditions resulted in recourse to quarterly budgets and the constant need to adjust budget appropriations through the year, which in any case became increasingly irrelevant in conditions of high inflation. Mechanisms to ensure in-year adjustment became crucial elements of the budget system. The consequence of these developments was to increase the importance of budget execution at the expense of budget preparation, with a parallel shift in power away from the Budget Department to the newly created Treasury Department.

V. THE NEED TO IMPROVE EXISTING BUDGET MANAGEMENT PROCEDURES

The transition process increasingly entailed a reorganization of economic policymaking. To the extent that the old planning orientation remained, it was more difficult to achieve this reorganization. This legacy of the planning system posed a number of constraints in transforming budget management into a more modern system geared to a market economy.

The institutional arrangements of budget management

One noticeable institutional feature was the relative status of line ministries with respect to the MOF. In the former Soviet budget system, the plan determined resource allocation, and the line ministries controlled resource allocation within broad economic sectors of the plan. This meant that the ministries were primarily responsible for budget preparation and execution in their respective sectors. The MOF played a rather passive role, consolidating the sectoral budgets and monitoring their execution throughout the year to ensure adequate budget funding. Similarly, in the budget execution phase, the MOF acted as a central funding agent, "distributing" funds to ministries so that they could adequately fund planning targets in their respective economic sectors.

The lack of status of the MOF

Since the planning process exerted real control over resource flows, and the MOF was viewed primarily as the financing agent for the plan, the MOF lacked special status. Indeed, since the plan attempted to ensure overall balance in the economy, important centralized stabilization functions typically found in ministries of finance in OECD countries were absent. The

consequence was typically a MOF subservient to the powerful planning ministry (Gosplan)—a relationship that sometimes lingered into the 1990s in some FSU countries with Gosplan's successor, the MOE. However, even when this relationship was corrected, the MOF continued to be one ministry among other, sometimes more powerful, ministries (like Defense and Interior), and did not easily attain the status of the first among equals, as is typical in most OECD countries.

The internal organization of the MOF

The internal organization of the MOF in FSU republics inherited features arising from their previous subordinate function as the financing arm of the national plan. Three features were notable. First, the MOF organizational structure reflected the importance of "branch functions," which formerly dealt with the budgetary financing of major economic sectors identified in the plan. Second, as indicated, there was generally a lack of centralized functions to implement macroeconomic forecasting, analysis, and policy, which, in the past were the responsibility of Gosplan. Third, there was a limited centralized accounting function, which was previously the prerogative of the central bank (Gosbank), which also had some verification powers to ensure the correctness of payments and receipts and to report their details. Budget-supported institutions did, however, follow detailed compliance-oriented accounting to prepare year-end statements of financial and physical assets and liabilities.

The continuing influence of the previous planning system as an external constraint on budget reform should not be underestimated. All of the above features of the planning process persisted to varying degrees in the FSU republics—including Russia—throughout the 1990s, and imposed external constraints on attempts to reform the budget system. As a consequence, restructuring of the budget system necessarily involved a wider focus—the legal framework, institutional arrangements, and the system of public administration as a whole.

In addressing the weaknesses previously identified, it was perhaps not surprising that reform of budget management was not tackled as a system but in a piecemeal way. Inevitably, in the rather turbulent environment of the 1990s, a balance had to be maintained between undertaking long-term reforms and the unavoidable needs of crisis management. Concurrently, reform energies had to be balanced between *improving* current budget procedures with the need to develop and introduce *new* budget management functions. Certainly, the need to improve budget procedures was underlined by the difficulty in accommodating the short-run demands of a crisis environment. Being ill-equipped for this new role, macroeconomic management often degenerated into short-run responses to recurring crises. It is possible to identify a number of causes for this arising from poor budget management procedures.

Incomplete budget coverage

To use the budget successfully as an instrument of macroeconomic stabilization, it is important to be able to measure its overall impact on the economy. From this viewpoint, the Russian MOF found itself handicapped. A large part of government activities was excluded from the operations covered by the budget—the large extrabudgetary funds, the lower levels of

government that were required to assume increasing expenditure responsibilities, a large number of unknown contingent items, indirect subsidies through the extension of credit by the central bank, and foreign grants in kind. The compartmentalization of government transactions, by the earmarking of revenues for particular expenditures, which occurred in major extrabudgetary funds and underlay budgeting for foreign economic activities, also cut down the MOF's flexibility to adjust aggregate spending.

Fragmentation in control of fiscal aggregates

Institutionally, there were a number of constraints on the ability of the MOF to adjust fiscal aggregates. The most conspicuous was that key budget aggregates were under the control of different institutions, although the assignment of responsibilities was often fluid. In Russia as of end-1992, budget estimates of foreign transactions were the responsibility of the Department of Monetary and Financial Regulation, not the Budget Department. With regard to foreign debt transactions, initially the responsibility was shared with a new Foreign Credits Department of the MOF, the specialized foreign financing and trade banks (the Vneshekonombank and the Vneshtorgbank). As a result of this institutional fragmentation, the MOF had no complete register of foreign debt and no register of guarantees. Similarly, with regard to capital investment in the budget, this was the joint responsibility of the Ministry of Economy (formerly the Union Gosplan) and the MOF. With respect to the financing of government operations through domestic government securities, the responsibility was shared with the government Securities and Financial Market Department of the MOF and the Bank of Russia (BOR),⁷ with little apparent coordination between them. Moreover, there seemed to be no coordinated approach to budget management by key macroeconomic managers—Central Bank, MOF, MOE, State Tax Service (later Ministry of Taxation)—which often displayed independent and contradictory approaches to policy questions.

Inadequate information

Flexibility was further reduced by the accounting system geared to verification and compliance so that it generated information necessary to ensure this type of control. As a consequence, emphasis was on recording the last stage of the spending process, and the MOF only aimed for cash control over the spending ministries, but not of prior stages of spending by the lower-level spending units (SUs). Concentrating controls on cash disbursements without controlling the commitments of SUs not only led to disruptions in orderly resource allocation within ministries but also to SUs accumulating arrears to the rest of the economy.

The absence of commitment reporting, a neglect of contingent items, reporting on an institutional rather than on an economic basis, emphasizing the final stage of spending, compiled in great detail, and reporting only with a considerable time lag—were all handicaps that were progressively revealed in the 1990s. The resulting lack of fiscal management

⁷ Formerly, Central Bank of Russia (CBR).

information prevented the rapid corrective action that was required in order to anticipate and redress deviations from budget targets.

Lack of forecasting capability

Macroeconomic managers are allowed some degree of flexibility insofar as they are able to predict future developments. Initially, macroeconomic forecasting was carried out almost exclusively by the MOE. However, having emerged from the planning system, the MOE tended to focus on growth of output of the main sectors of the economy and on sectoral-price projections rather than on financial aggregates. Initially, there was very limited forecasting capability within the MOF. This could be justified to a limited extent on the revenue side because of the Tax Ministry, but not with respect to spending. Unfortunately, the highly uncertain environment for budget preparation was not conducive to the development of forecasting. Consequently, in the absence of timely and comprehensive reporting, and without the ability to forecast future developments, budget execution was only capable of reacting to, rather than anticipating, developments in the economy.

Limited financial planning

The lack of flexibility encountered in the ability to adjust expenditures was reinforced by limitations in financial management. There was little cash management in the sense of evening out the fluctuations in receipts relative to expenditures. This arose partly from poor revenue forecasting but also from the lack of flexibility in the financing arrangements for government. In the absence of a securities market, the government was dependent on loans from the banking system, vetted by the legislature, with no overdraft facilities at the central bank.

VI. THE STRATEGY OF IMPROVEMENT: AN OVERVIEW OF REFORM IN THE 1990s

To some degree, all the above deficiencies of the budget system were recognized in the 1990s and addressed, by progressively instituting a number of changes:

- Consolidating budget and extrabudgetary transactions to better control them, and to derive a more complete picture of the impact of government operations on the economy.
- Concentrating economic decision-making functions in the MOF, providing it with the powers of consultation and approval for major economic aggregates with respect to other institutions.
- Improving the type of information available to the MOF by including stages of the spending process prior to the final cash stage, and in a form that revealed the economic nature of the spending by improving budget classifications.
- Speeding up the information made available to the MOF, by requiring short summary "flash reports" from the ministries on the activities of their SUs, and through a network

of treasury offices developing a parallel reporting system, centralizing the accounting function within the MOF.

- Establishing a department in the MOF responsible for forecasting and analysis of macroeconomic and fiscal developments.
- Integrating this forecasting function with cash management operations within the MOF to better plan the financing of government.

While recognizing that complete reform is in any of the above areas, there were two supporting areas which did much to consolidate the progress that was made. These changes—perhaps the most important—were in the legal and institutional framework governing the budget system; namely: the adoption of an organic budget law, and the separation of budget preparation and execution within the MOF by establishing a Treasury Department.

A new organic budget law

Budget legislation was reviewed, and modeling this on OECD lines, an organic budget law, or “Budget Code,” based on market-based principles, was adopted. Whereas it was inevitable that short-run considerations dominated the public expenditure management objectives of the Russian MOF and made it essential to design more effective mechanisms to facilitate short-run fiscal adjustments, at the same time longer-run implications of short-term measures could not be neglected. The Russian authorities did not lose sight of the fact that over the medium term it would also be necessary to develop and implement a budget management system compatible with a market-based economic system. Therefore, from 1995, work commenced on a new Budget Code (organic budget system law) that would resolve these medium-term problems. Reorienting the budget system in this way required finding sustainable medium-term solutions to the systemic problems previously identified.

Establishment of a treasury system

The MOF restructured its functions separating budget preparation from budget execution and gave a newly created treasury department responsibility for the latter. Apart from changing the legal framework, to accommodate reforms in budget procedures throughout the 1990s, adjustments to the institutional arrangements for budget management also took place. Most important of these was the creation of a Federal Treasury Department in the MOF in 1994, charged with the execution of the budget, and with government accounting and general cash management operations for the government. Debt management, however, continued to be handled by other MOF departments, in a somewhat fragmented way. At first, the chief priority in developing a treasury system was the establishment of a branch network throughout the Federation to replicate the work that was previously undertaken by the BOR network. Much resistance initially came from the line ministries, who opposed entering the treasury system, and also from the BOR, who often did not cooperate with Federal Treasury (FT) initiatives. The turning point came in 1998, with the Presidential Decree on the Treasury's Development, which for the first time gave a definitive view of the FT as the main controller of budget execution in

the federation and the custodian of the government's cash resources. By the end of the decade, the FT system had over 2000 branch offices nationwide and an estimated 48,000 employees.

Broadly, a strategy of budget system reform emerged in 1990s that would tackle the main weaknesses in the budget system. Generally, the main elements of this reform process have focused on:

- *More realistic budget estimates*

This was principally carried out by developing capacity for macroeconomic planning, to provide a more realistic framework for the budget; by improving budget classifications; and by moving away from physical planning concepts when preparing budgets in agencies.

- *Greater control over the payment process*

This was accomplished by better reporting on the different stages of spending, on commitments as well as cash, increasing the coverage of the budget and expanding the scope of fiscal reporting.

- *Restructuring the accounting system for management purposes*

This involved moving central accounting out of the banking system into the MOF, developing a treasury ledger system, and reorienting the accounting away from the emphasis on compliance and final accounts, to provide management information on the in-year progress of budget execution.

- *Developing financial management and planning functions*

This concentrated on better and more detailed financing plans, continuously updated in the MOF, based on more timely reports from budget institutions, alongside a better use of cash by consolidating government bank accounts to move to a single main account at the central bank.

These elements are described in more detail in Tables 1–4 below.

Table 1. More Realistic Budget Estimates

Problem	Solution	Progress in the 1990s
1. A lack of an <i>overall macroeconomic framework for the budget</i> by which to set fiscal targets and provide the macroeconomic parameters on which to base budget estimates at the ministry level.	Develop within the MOF the technical capability to monitor and forecast macroeconomic developments, determine consistent fiscal targets, and facilitate the construction of budget estimates based on these targets.	The MOF established a Macroeconomic Department that worked closely with outside research institutions and the IMF in establishing the macroeconomic framework in which fiscal policy and the budget could be framed.
2. The <i>classification of expenditures</i> , inherited from the previous planning environment, was not economically meaningful in an increasingly market-based economy and hence not relevant as a basis for fiscal policy.	Adopt a classification system more suited to a market economy, allowing a better analysis of the economic content of spending, and hence a better indication of the budget's impact on the economy.	Progressively, changes were made in the economic classification of the budget to remove functional elements and to move the system to one more compatible with international standards (e.g., GFS). Although a few anomalies remain, progress has been marked in this area.
3. <i>Budget preparation</i> at the spending-agency level was based on rigid use of physical norms, based on line items rather than activities and programs, and there is a general absence of economic analysis of alternative resource allocations.	Switch budget preparation from line itemization to an activity/program structure. Adopt market-based techniques of cost benefit and cost effectiveness, to be applied to activities and projects, that will provide more realistic costing of alternatives as a basis for identifying unproductive spending and deciding on efficient cutback plans.	Unfortunately, the functional classification system still lacks clearly defined activities/programs as its base, and still bears the stamp of the inherited soviet system.

Improvements were also instituted in the following main budget execution areas:

Table 2. Control Over the Payment Process

Problem	Solution	Progress in the 1990s
1. <i>Controls focused on credit releases</i> which created problems in ensuring the overall spending limits are not breached in a situation of continual cutbacks, and, without concurrent changes in commitments this caused considerable inefficiencies and disruptions in the spending ministries, manifested in government arrears.	Record and report all stages of the payment process so that limits can be set on commitments as well as cash.	During the 1990s the need for commitment control was established, and in 1999 a limited system of commitment registering was introduced. However, the system is not comprehensive and has not moved to the next stage of control, and commitments are not yet reflected in treasury accounting.
2. <i>Large components of fiscal operations were left out of fiscal decision making</i> , being carried out by extrabudgetary funds, quasi-fiscal operations through the banking system, and a substantial local government sector.	Bring the extrabudgetary accounts into the MOF's financial management system, register all lending in the system. Since an increasingly large component of government activity was devoted to lower levels of government, these were encouraged to register their operations in this system.	Throughout the 1990s, the control problems caused by extrabudgetary funds (EBFs) were recognized. EBFs, as special funds, were reduced in number so that by the 1999 budget there were only five. Of course, there remain numerous off-budget accounts of budget institutions. Direct lending through the banks was largely discontinued—at least at the federal level. Attempts were made to exert more control over regional finances—particularly in those oblasts dependent on transfers from the federal government. In 1999, of the total of 87 regional budgets, 53 had their revenues serviced by the federal Treasury and only 17 had separate categories of expenditure transacted through the treasury. In comparison, out of almost 11,000 local governments 31 had their entire revenues and expenditures transacted through the treasury system.
3. <i>Using the banks to receive revenues without parallel development of an adequate reporting system from the tax administration</i> slowed the process of crediting receipts to government, and added to cash balances in the system.	Introduce a parallel system of reporting from the tax administration, and move tax sharing from the banks to the MOF.	Tax receipts reports were sent to the tax administration but since the federal Treasury is in charge of tax sharing, the reports were first received there and then passed to the tax administration. In the Moscow oblast, tax payers still fill in separate tax returns to different levels of government, bypassing the treasury tax sharing and creating the need for parallel databases on taxpayers.

Table 3. Restructure the Accounting System to Form the Basis of a Financial Information System

Problem	Solution	Progress in the 1990s
1. <i>Government accounting was largely in the hands of the banking system, operating through the branch network of the former BOR, providing the MOF with incomplete information and only at the last stage of the spending process.</i>	Move the accounting of government transactions out of the banking system into the MOF to speed up and improve the quality of information at the disposal of the MOF for policy decisions. This will be accomplished by developing a ledger system in the MOF as a central register to maintain government accounts on a current basis on all stages of expenditure—commitments, verifications, and payment orders issued.	The Federal Treasury has assumed the role as the government accountant and has developed a ledger system to record government transactions on a cash basis. There remains a need to restructure the accounting system and the chart of accounts on which it is based.
2. <i>The accounting system was based on a budget classification system inherited from the planning system, which will become increasingly irrelevant in a market-based economy for analysis and policy purposes.</i>	Develop an accounting plan based on a budget classification system that allows greater scope for economic analysis.	Classifications have been adapted and accounting has changed, but much work remains to be completed in this area.
3. <i>Reporting from the ministries to the MOF was inadequate—timely reports were overly aggregative, and only in cash and not commitment terms; detailed reports existed but were obtained with considerable time lags that negated their value for fiscal policy purposes.</i>	Develop timely reporting of all stages of spending from commitments to cash, as a basis of controlling spending limits both at the commitment and cash stages—the former forcing consideration of adjustments in policies.	"Flash reports" were developed, but reporting continued to be geared to compliance—i.e., generating reports in great detail but with substantial time lags. Special reports on arrears, and then commitments, were only partially covered toward the end of this period.

Table 4. Develop Financial Management and Planning Functions
(based on a Treasury Single Account)

Problem	Solution	Progress in the 1990s
1. There was <i>little analysis of overall economic developments</i> , with which to guide the direction and timing of budget execution. Paralleling this, there was little analysis of the impact of budget aggregates on the economy and overall liquidity.	Prepare a detailed financing plan, including major budget aggregates and financing flows. This would be updated regularly by the MOF on a rolling basis, depending on forecasts of key macroeconomic parameters and would be consistent with monetary and external developments.	Financial plans are prepared at the beginning of each budget cycle, but there are doubts as to their quality and there is little adaptation of these plans to economic circumstances and on a rolling basis—at least only for the immediate week and at most a month ahead. Financial planning has remained short-run and reactive rather than proactive.
2. There was <i>little forecasting of cash inflows and outflows</i> to the government that would allow a less abrupt curtailment of spending and achieve the more orderly programming of government financing.	The more timely provision of information provided by the MOF financial management system on present cash position of the government would form the basis for detailed cash flow forecasting, the setting of spending limits, and the programming of financing.	Forecasting techniques have been developed, but are primitive and not fully integrated to cash programming needs.
3. <i>Financing arrangements did not allow flexibility in the government operations</i> , and did not coordinate the government's financial needs with those of the central bank's needs to control liquidity in the economy.	Within the framework of the financial plan the MOF would undertake day-to-day financing operations, in cooperation with the National Bank, and in the context of an outstanding line of credit.	The Debt and Securities Department of the MOF does cooperate with the BOR in decisions regarding the issue of government debt, however, this has not worked smoothly in the past.
4. <i>Multiple accounts for both revenues and expenditures in the banking system slowed down cash transmittal</i> and led to uneconomic accumulation of credit balances, and in some cases cash balances, on which the MOF was charged interest.	Switch all bank accounts to accounts within the MOF, and consolidate all banking transactions in one MOF account at the central bank. In this way, if any unused credit balances exist, they will be at the disposal of the MOF to reduce its overdraft with the BOR, and not the banking system. The use of a single account at the BOR, which will improve cash management and financial operations generally.	The principle of a consolidated treasury single account (TSA) has been accepted, and the bank accounts of all budget institutions covered by the treasury system have been closed, allowing a consolidation of cash balances. Because of weaknesses of the banking system it has not been possible to operate treasury regional accounts as transit accounts, on a zero balance principle, and at the same time many budget institutions are outside the Treasury and numerous others maintain nonbudget accounts in the banking system.
5. Lack of cash forecasting precluded financial planning and led to short-term reactions to satisfying government financing needs that added to the cost and created difficulties for the BOR's conduct of monetary policy.	Develop cash forecasting, to aid in the planning of financing operations and, in particular, maintain debt registers so as to be able to project debt service obligations.	Debt registers are maintained by the Debt and Securities Department of the MOF, and projections of debt service obligations are available in a timely manner. This work is not yet fully integrated into government financial planning.
6. The lack of flexibility in adjusting to the cash position of government was aggravated by the lack of suitable financing instruments.	Regularize the government's credit line from the central bank on more market-related terms, up to some specified limit, and in the medium term develop a market in government debt.	Given the history of failure to meet its obligations, the lack of confidence has hindered the development of a market in government debt.

VII. THE REMAINING AREAS FOR REFORM

There are many constraints on the full implementation of the Budget Code, which will have to be removed. First among these is the need to better align resources with budget commitments to make the budget a more realistic expenditure plan. To do so will require a fundamental review of the role of government in the Russian Federation and obtaining a more realistic appreciation of the size of core government activities that can be financed from the present tax base. Addressing these issues requires a high degree of political commitment and a concentrated effort by the central agencies of government. This most fundamental structural issue lies more in the domain of budget policy rather than techniques of budget management. However, the failure to address this fundamental issue will have adverse impacts on other improvements to the budget process, and the ability to fully implement the Budget Code. It is apparent that this had been recognized and in 2001 the authorities began a systematic review of budget programs.

The need for a fundamental review of government operations

The 1990s was characterized by basic imbalances between budget commitments and available resources to fund them. Partly this arose from the fact that the budget represented an incomplete list of commitments since it did not fully include the liabilities of the government arising from entitlements from other legislation. In Russia these entitlements are prolific, covering almost all spheres of life. While it must be agreed that the quantification of these entitlements is difficult, and that any attempt to limit these provisions is not easy, a beginning has been made to assess their size and develop a strategy to rationalize them. Perhaps more important, in the past there has been a continual failure to face decisions on what should be the core role of government—to identify what constitutes government services and what does not—meant that no explicit policy decisions were taken on non-essential services to be scaled back or eliminated.

Without such a fundamental review of the structure of government operations, unrealistic budgeting has been the rule. Insufficient revenues to meet all budget needs resulted in continuous forced expenditure sequestration and a lack of efficient controls over budgetary commitments, forcing fiscal adjustment from the federal to lower levels of government, and creating a large gray sector within government that largely went unrecorded and escaped regular budgetary controls. These included: payments in kind transacted at nonmarket clearing prices that represented a hidden subsidy to nonviable enterprises and perpetuated soft budget constraints; tax expenditures that were unreported but pervasive, constituting significant indirect subsidies to large enterprises that were not reflected in the budget (so-called “quasi-fiscal operations”); tax offsets against government arrears represented a substantial loss for budget recipients and implicit subsidy to providers owing to higher prices on arrears and discounts on tax payments; and expenditure arrears have been endemic in key sectors, such as energy and military procurement, where bills were settled in kind or by noncash means, and aggravated these other problems.

Slowly, there has been a realization that all of these ad hoc solutions not only reduced the transparency of the budget process, but also led to major inefficiencies in resource allocation,

and compounded the difficulty in redressing the fundamental problems of fiscal management. Moreover, they provided a profitable business for intermediaries (discounting and floating associated financial flows) and a huge source of rent seeking. As a result, large vested interests arose to defend these practices and may still represent an important barrier to future reform. From 2000, there was a noticeable change in policy, at least in some sectors, to challenge such vested interests.

The need to apply the Budget Code to all government operations

The main elements of the reform strategy, outlined in the previous section, have largely been incorporated in the new budget system law, the Budget Code, first implemented in the budget of 2000. With the adoption of the Budget Code, the reform of the Russian budget system took a significant step forward. This fundamental budget system law took four years to be passed by parliament and to be promulgated. Within the law it is possible to detect some features inherited from the previous system, but for the most part the budget system specified in the law is based on principles and practices commonly found in OECD countries.⁸ However, the passing of this law must be regarded as the beginning of the next phase in budget system reform rather than its final solution.

At present, large components of government operations are not fully compliant with the Budget Code. There has been some progress, however, in its extension to a number of areas that in the past were outside its control—the MOD, extrabudgetary funds, and local budgets.

The largest exception to the Budget Code's coverage has been the Ministry of Defense. The Russian defense establishment operated throughout the 1990s as an enclave that was independent of the rest of the budget and normal budget practices. This also is changing. The Budget Code is recognized as applying to all federal ministries, and there is a program to progressively execute the MOD budget through the federal treasury system. Similarly, extrabudgetary funds have been subject to more budget control. By end-FY 1999, there were five major funds at the federal level—the Pension Fund, the Social Insurance Fund, the Fund for Medical Insurance, the Employment Fund, and the Road Fund—which were extrabudgetary. By Art. 7 of the FY 2001 budget, most EBFs were eliminated. The new government chart of accounts includes new heads of accounts for the three main EBFs—the Pension Fund, the Social Insurance Fund, and the Compulsory Medical Insurance Fund. Although technically inside the budget and under the FT, these funds have in the past used their own classification system and have followed their own accounting rules. This implies that the true integration of these funds will take some time to be technically consistent with, and fully integrated into, treasury accounting and reporting.

⁸ A critical appraisal of the Budget Code is contained in J. Diamond: "The New Russian Budget System: An Assessment and Future Reform Agenda," IMF, 2001 unpublished.

The requirement on local governments to conform to the Budget Code, the imposition of a common budget classification system, and their own lack of expertise to do so, has meant that local governments have turned to the Federal Treasury to carry out budget execution functions for them. By entering the treasury system, they will be required to conform to other aspects of the Budget Code. In theory, lower-level governments enter the FT only on a voluntary basis, although in practice there is a current trend in government policy to extend more central control over the regions and hence greater pressure for them to enter the system. At the same time, given past arrears problems, suppliers (especially of utilities) have often insisted that the local government be in the system before they sign contracts. There are clear indications, therefore, that the FT will most likely have to expand its operations in respect to regional and local governments. Processing local revenues may not be too difficult, but processing lower-level expenditures is likely to prove problematic, perhaps straining the FT's administrative capacity.

The need for further capacity building

To fully implement the Budget Code and to increase its coverage will require a major effort in capacity building, especially in developing the federal treasury system and in strengthening supporting functions such as internal and external audit.

There is a major effort currently underway to fully develop the federal treasury system. This focuses on four main elements. First, the enhancement of government accounting to bring it to international standards and to complete the development of a treasury ledger system that will record all stages of expenditure, from appropriation, through commitment, verification, and final cash payment. Second, the consolidation of all government cash resources through the creation of a treasury single account (TSA), to improve government cash management. This will involve completing the coverage of the treasury system, by inclusion of all security ministries, and the off-budget activities of budget institutions, closing the associated bank accounts and transferring them to ledger accounts in the treasury. Third, substantial improvement in the government financial management information system by developing a system of reports to support an improved central financial planning capacity within the MOF. Lastly, to fully computerize the treasury system network to implement these reforms and carry out this increased workload.

Russia has no tradition of audit, and this function remains weak. Russia inherited a control department in the MOF, which operated as an investigative rather than preventative institution carrying out special investigations on alleged irregularities and fraud. Overlaid on this traditional audit function Russia instituted an external audit institution, the Chamber of Accounts. In terms of internal financial control, there has been a move to refocus the work of this MOF central department, which has been renamed the Department for State Financial Control and Audit. However, the approach retains the concept of a central inspectorate, and also

the emphasis on control and investigation of irregularities rather than the more accepted OECD concept of internal audit as an aid to agency budget management.⁹

To support a reform program in public expenditure management, it is essential to establish external checks on budget performance. In this regard, the external audit function is critical. International experience suggests that this function is most effective when the supreme audit institution has genuine independence from the executive, with timely access to comprehensive budget execution data. While reporting to the legislature, it is able to pursue a systematic, independently determined program of audit, with separate budgetary provision for any ad-hoc investigations required by the legislature; and, confines its role principally to ex-post audit, without compromise from any parallel engagement in the activities of budget formulation and execution.

In Russia, the Chamber of Accounts has been hindered in carrying out this role owing to three main factors: (i) inadequate expenditure reporting and accounts preparation by the executive; (ii) diversion from a systematic work program by the intervention of ad hoc investigations requested by the legislature; and (iii) dilution of its core responsibilities for ex post audit by other tasks such as advice on budget formulation, intervention in budget execution, and an enforcement role with respect to implementation of audit findings and penalties. In the future, it will be necessary to address these issues and to technically reinforce the Chamber of Accounts with more suitably qualified staff, computerization, and a suitable training program.

VIII. LESSONS FROM THE RUSSIAN EXPERIENCE

The first lesson learned from the experience of Russia is that reforming budget systems takes time. It has taken almost a decade to adopt a legal framework for a market-based system. Even with this advance, the Budget Code is not fully implemented and it is openly admitted that it will take time to ensure full adherence to the Code. The slow speed of reform reflects the fact that this institutional transformation is not just a technical matter. Apart from the need to overcome capacity constraints, a more important brake on the process is the need to make fundamental policy choices.

Inevitably, it has taken time to recognize and accept some of the shifts in the internal balance of power implied by the move to a market-based budget system. Many of these shifts are still in the process of being resolved. For example, the view of the state's role in economic activity is clearer but still not fully in line with a market-based system found in most OECD countries. The balance of power between the legislature and the executive branch also has been clarified, but not fully settled. As noted, although less chaotic than was the case in the initial stages of the transition process, the balance between central and other levels of government is still evolving.

⁹ The role of internal audit in budget management is discussed more fully in J. Diamond, "The Role of Internal Audit in Government Financial Management," IMF, 2001, unpublished.

Until these issues are resolved, the legal framework within which the budget must be managed is often ambiguous and sometimes contradictory.

With the adoption of the Budget Code, the paramount role of the MOF as the financial manager of the government has been confirmed. However, there still exist problems over the division of responsibilities between different departments of the MOF. For example, this paper has highlighted the problems that arise from the role of the Budget Department in the budget execution process, and there are limits on the role of the treasury as the government's cash manager when debt management is undertaken elsewhere. The role of external audit in the various stages of the budget process also still lacks clarity, although has not been a source of conflict simply because of the lack of capacity of the Chamber of Audit to fully carry out its mandate.

Accommodating these constraints has led to an imbalance in the reform process. As indicated, progress has been much faster in reforming budget execution than in budget formulation. In budget execution, where there was a clear gap to be filled, and where there was no vested interest to overcome, progress was easier. For example, with the withdrawal of the BOR from treasury operations, there was little hindrance, and indeed an incentive, to set up an alternative system. This was reinforced by the fact that the treasury's operations were viewed more as a technical function, involving limited policy content. In contrast, reforming budget preparation has proved much more difficult. This involves replacing an already existing system, with its own vested interests, and in an area where policy decisions cannot be avoided. One of the most important of these policy issues revolves around who has the authority, and the scope of that authority, to make policy decisions in the budget area. In terms of the reform of the budget system, the result has been that further improvement in budget execution is increasingly being held back by poor budget preparation. Future reform requires that this imbalance be corrected.

Another cause of the slowness in reform has been the unstable economic situation faced by policymakers. Opinion is often divided over whether crisis stimulates and speeds up reform, by revealing deficiencies in the present system, or acts as a brake to taking decisive actions with a longer-run pay-off. In the case of Russia, the experience of institutional reforms, such as that examined in this paper, seem to lend more support to the latter argument. While the severe fiscal stress experienced by Russia after the breakup of the Soviet Union revealed the weakness of the budget system, it is doubtful that it acted as an immediate stimulant to reform. A learning period seemed to be required. There was clear tendency to first try to adapt the old system, to muddle through, and when this was demonstrably not possible, only then to attempt to reform the system as a whole. Even now, after the adoption of the Budget Code, in many areas of the budget system there is a clear tendency, if only because of the need to overcome administrative capacity constraints, to adapt and to modify the system piecemeal to bring it into line with the Code.

Undoubtedly, while crisis provided the incentive to reform, there is a certain tension in this relationship so that the degree of crisis is important—too much can be disruptive and counterproductive for reform. Certainly, the recent increase in the oil price, in eliminating fiscal stress, at least in the immediate term, has provided a window of opportunity for accelerating

reform in this area. Whether this opportunity will be seized, or whether it will be squandered in maintaining budget inefficiencies, is an open question for future budget system reform in Russia.

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