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## **The Long-Term Impact of Structural Reforms on the Budget of the Russian Federation**

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### **Abstract**

The detailed analysis performed in this work shows that the Russian budgetary system is extraordinarily cumbersome and inefficient, and has a host of shortcomings that are systemic in nature and cannot be resolved using the measures of macroeconomic policy.

The principal systemic problem of the Russian budget is the imbalance between spending obligations and the revenue base. The true scale of the spending portion of the budget is significantly higher than the official statistics show -- according to estimates, it is about 53% of the GDP, while revenues are just 37% of the GDP (in 1999). So the principal goal of state economic policy in the near term should be to eliminate this gap by pursuing structural reforms.

In view of the slight potential for increasing revenues, the principal direction of state policy should be reducing expenditures.

But cutting back spending is impossible without profound structural transformations in the budget sphere. The essential transformations go beyond the bounds of fiscal policy, and include structural and institutional reforms in various areas such as the social sphere, defense, the system of state administration etc.

The revenue side of the budget should be subject to reform as well, principally the system of taxation, which has become one of the main impediments in the way of economic growth. The basic directions of tax reform should be the reduction and even distribution of the tax burden, with the increased efficiency of tax monitoring and administration.

The Russian budget should decline to a level of 40--42% of the GDP with zero deficits within 5--10 years if these structural reforms are effected, which roughly corresponds to the lower limits of budgets in the OECD countries.

### **1. Introduction**

The system of state finances, and the budget system in particular, is an inalienable part of a market economy; it supports the functioning of the state and creates the conditions for socioeconomic development. The state budget, which unites the budgets of all levels of

the fiscal system and off-budget funds, should be a complete financial reflection of the participation of the state in the economy and its interaction with society.

Russia inherited an economy from the socialist system that was based on the broadest of economic powers for the state, and an enormous state sector accordingly. Attempts have been made during the period of reforms to move to a market economy, with reduced dimensions for the state sector. A tax system was constructed that was based on market principles. It may be said that some relative successes were achieved in the area of reducing spending. But more detailed analysis shows that the Russian budget system is extraordinarily cumbersome and inefficient, and has a host of shortcomings that are systemic in nature.

The goal of this work is to ascertain and analyze the problem areas of the Russian budget system. It will be shown that the solution of these problems is impossible through fiscal policy measures alone, and that it requires sweeping structural and institutional reforms in many areas of the Russian economy. Only structural reforms can lead to a resurgence of the system of state finances in the long run, and create conditions for the long-term and steady development of the Russian economy.

### *The structure of the budget sector in Russia*

The state budget of Russia consists of the budgets of three levels, depending on the levels of authority with the corresponding powers. The budget at the federal level consists of the federal budget and federally subordinate off-budget funds. The budgets of regional and local or municipal subordination have an analogous structure. Furthermore, some ministries and departments have their own off-budget funds, through which they conduct operations that are related to budgetary operations.

Unfortunately, the lack of transparency in budgetary statistics and shortcomings in the data do not make it possible to determine precisely the size of the budget sphere in Russia. The expanded budget includes the federal budget, regional and local budgets, and some off-budget funds, which include social off-budget funds, territorial road funds, and two departmental off-budget funds. That structure is determined by the accessibility of data on those budgets.

Before getting started on an analysis of the budget sector, it is necessary to make a few definitions and clarifications, including of a methodological nature, and to define -- more precisely, to narrow -- the field of analysis.

The expenditures of virtually any nation include spending to service state debt. The interest spending in Russia has risen substantially over the years of reforms. The soft fiscal policy (the lack of real reforms on both the expenditure and revenue sides) and the necessity to finance the budget deficit, and by and large through borrowings at that, has caused state debt and the spending to service it to grow. Federal interest spending totaled 3.6% of the GDP in 1999 alone (reliable information is lacking for the other levels of the budget, although there has obviously been borrowing), even with a regard for the

restructuring of the foreign debt of the former Soviet Union, while in 1992 it was 1.1% of the GDP. The problem of state debt is generally a macroeconomic problem, and in the short run it does not depend on the actions of the authorities in the area of structural reforms. So it will not be considered in this work. But this problem does superimpose tight fiscal constraints on the utilization of the resources base of the budget, and creates additional incentives to reform the other part of the budgetary sphere -- non-interest spending.

We need to distinguish the cash execution of the budget from the size of the budget based on obligations. The former is defined as the financing of expenditures as it is actually carried out, and that moreover regardless of the forms of settlement, be they cash or offsets. Expenditures based on obligations are the magnitude of all budget obligations of the state that are openly or tacitly defined by legislation. One characteristic feature and serious problem of the Russian budget is the discrepancy between the cash execution and the magnitude of budgetary obligations. This problem will be considered in greater detail below.

## **2. Analysis of the current situation in the budget sphere**

The expanded budget, as has already been noted, includes the federal budget and regional and local budgets, which together constitute the consolidated budget, as well as the social and other state off-budget funds (the Pension Fund, the Social Insurance Fund, and the Employment Fund, among others). The relative contribution of each of these three components to the expanded budget has undergone serious changes in recent years. The regional and local authorities gained significant autonomy in determining their budget spending in 1992, after many years of simply executing the instructions of Gosplan [the State Planning Committee]. The expenditures of local budgets constituted 15% of expanded spending in 1992. Their percentage rose to 35% in 1999, while declining from 75% to 40% as a percentage of the federal budget. The share of off-budget funds rose from 10% to 25% accordingly. Since the revenues and expenditures of the local budgets and off-budget funds as a whole were balanced in 1999, the deficit of the expanded budget is actually a federal deficit.

[insert Table 1, page 4]

### ***Expenditures***

Proceeding from the dynamic of budget execution on a cash basis and the state financial policies being pursued, we can hypothetically delineate three periods.

The first encompasses the period from 1992 through 1995. During that period, there was an almost two-fold reduction in non-interest spending of the expanded budget, from 75% to 38% of the GDP. The cutback in spending occurred through the elimination of import subsidies and direct CBR [Central Bank of Russia] lending to sectors of the economy. Spending on debt servicing was insignificant during that period. It may be said that only

during this period (more precisely, in 1993 and 1995) was there a palpable decline in the expenditure obligations of the budget.

Federal budget spending decreased not only through reductions in budget obligations, but also as a result of the transfer of some spending authority from the federal to other budget levels. The authority for some social expenditures in particular was transferred from the federal budget to the regional budgets and off-budget funds. Federal spending as a whole had declined from 59% of the GDP to 18% by 1995, while it had increased from 6% of the GDP to 16% for the regional budgets. The spending of off-budget funds increased by 3% of the GDP during that same period.

The year 1995 is something of a separate issue in this dynamic. While in 1993 spending had declined through the elimination of subsidies and CBR lending -- that is, reductions in obligations -- in 1995 spending declined as a result of an implicit sequestering. The tightening of monetary and credit policy, given no changes in the budget and the institutional structure of the economy, led to an increase in non-payments, including tax payments. The government was formally fulfilling its nominal budget indicators, but only through the inflation tax. Budget spending declined significantly in real terms.

Despite the substantial decline in the deficit, fiscal policy continued to remain not tight enough, and most importantly, reforms were not carried out in the area of expenditures.

The situation was further aggravated in 1996, when the disposition of political forces was altered as a result of the presidential and parliamentary elections. This was reflected in fiscal policy as well. This period -- from 1996 through 1998 -- is characterized by even more inconsistent and irresponsible fiscal policy by the state.

After 1995, even these weak hints of reforms in the expenditure portion of the budgets effectively ceased by virtue of the political factors that predominated during this period -- the elections for president and parliament, the new "leftist" Duma etc. The effectively unchanged functional structure of the non-interest expenditures on a cash basis testifies to this as well.

Fiscal policy was formally aimed at raising social well-being and stimulating domestic industry through budget subsidies. This was reflected in unrealistic budgets and the other populist regulatory acts that were passed by the legislative authorities. The expenditure obligations of the budget not only ceased to decline, but even started to increase. A host of acts of legislation were passed, both at the federal level and the regional level, that increased social payments to the population or provided subsidies to enterprises. At the same time, virtually nothing was done to increase revenues as a steady resource base. The lack of effective measures to increase revenues forced the authorities to carry out sequestering, and caused indebtedness to accumulate.

Not one of the federal budget laws that were passed in 1996-98 was fully implemented, either in expenditures or in revenues. The laws on the budget did not include all the spending obligations of the federal budget therein.

Borrowing in both the domestic and the foreign markets was used to finance the deficit that arose even after sequestering, which led to growth in spending for debt servicing and to even larger cutbacks in the financing of the budget sphere, and increased indebtedness accordingly.

The first successes in placing Russian Eurobonds and developing the domestic debt market created the illusion of a sufficiency of resources to finance the budget sphere. It may be said that this was yet another indirect impediment in the way of budget reform, and consequently only aggravated the pressure on the budget. It has now become obvious that funds from foreign financial markets had to be used for the structural restructuring of the budget sphere, and not to repay indebtedness on wages, which is what was done.

Things were even worse at the regional level. While the federal authorities were operating under the squeeze of international financial organizations and were subject to greater social controls, there were effectively no outside controls at the regional level. Analysis is made more difficult by the lack of transparency in regional budget statistics (that problem will be considered below). Official data appeared on the debt servicing of the regions thus appeared only in 2000, while borrowing was being made during that period in both the domestic and the foreign markets. The deficits of regional budgets tripled in 1995-97 to 1.5% of the GDP.

The expenditures of the regions have risen by 2.7% of the GDP since 1995, and had reached 18.2% of the GDP by 1997. Non-monetary forms of settlements were being used more widely in regional budgets than at the federal level, and their percentage was about 45--50% in 1997. The expenditure implementation of regional budgets increased markedly as a result, but with increased arrears in wage and social payments therein.

It should be noted that the federal government started to undertake some measures in the area of spending policy in 1998. The Spending Economy Program was adopted in particular. One of the principal aims of the program was to reduce the number of personnel in budget-financed organizations and state administrative bodies, eliminate some budget-financed organizations, and do an inventory of -- and then reduce -- the indebtedness of the federal budget. Despite something of a positive impact, the program could not substantially rectify the condition of the budget sphere, since it contained only measures to reduce spending without structure changes in the budget sector.

Summarizing some of the results, it may be said that the 1996-98 period has been characterized by the lack of significant structural reforms and an easing of the already insufficiently tight fiscal policy, which combined with the relatively tight monetary [word missing] led to the crisis of August 1998.

After the consequences of the 1998 crisis were surmounted, the execution of the budget changed as a result of changes in the macroeconomic situation in Russia. The weakening of monetary policy and rise in world oil prices in 1999, which led to growth in budget

revenues, and the lack of significant sources of financing for the deficit led to reductions in the budget deficit, with cash non-interest expenditures remaining at approximately the same level.

The federal government was able to meet and even exceed the indicators of the law on the federal budget in 1999 for the first time over the years of reform. But the reasons for that are not so much from the efforts of the Russian authorities themselves as from the objective improvement in the financial state of taxpaying enterprises. The price increases for oil lessened the problem of non-payments, led to a rise in revenues, and made it possible, even in the face of an absence of significant sources of borrowing, to finance non-interest expenditures in full and repay wage arrears, avoiding their accumulation right up to the present time.

Whereas in 1998 the federal budget had a primary deficit of 1% of the GDP on a cash basis, it ended the year 1999 with a primary surplus of 2.1% of the GDP, while in the first half of 2000, according to preliminary data, the federal budget had an absolute surplus of 3% of the GDP.

An inventory of the accounts payable of budget-financed organizations was made in the context of the Spending Economy Program, and the conversion of the federal budget to a treasury system was begun. But no fundamental changes occurred either in the structure of cash expenditures or, the more so, in the structure of expenditure obligations.

The regional budgets also suffered from the 1998 crisis. The spending of the regions declined from 18.2% of the GDP in 1997 to 14.8% of the GDP. Spending on the economy (by 1.5% of the GDP) and social expenditures (by 1.6% of the GDP) were especially heavily reduced. The expenditures continued to decline in the following period. They dropped another 1% of the GDP in 1999 to 13.8% of the GDP, and to 10.8% of the GDP in the first quarter of 2000. One of the main factors in the reduction was the decline in subsidies for housing and municipal services, from 3.5% to 2.7% of the GDP.

### *The structure of expenditures on a cash basis*

We will try and summarize the analysis of the cash implementation of the budget over the years of reform.

The expenditures of the expanded budget declined from 76% of the GDP in 1992 to 36.5% of the GDP in 1999, and there was a significant redistribution among the budgets at various levels therein. The share of federal expenditures declined by almost half, to 40%, as a result of the transfer of some spending authority to the regions and off-budget funds, which almost tripled as a percentage of the expanded budget. But these changes occurred before 1994, and as can be seen from the tables, the structure of expanded budget spending has remained fundamentally unchanged compared to 1995.

Spending on the social sphere plays an important role in the structure of expanded budget spending. About half the financing for this section goes for off-budget social funds. Some of the social expenditures in the initial stages of reform were shifted from the federal budget to regional and local budgets. What is more, some social expenditures were transferred *de facto* in the form of "federal mandates." Despite this, the percentage of the regional budgets has declined somewhat in recent years. This is due to the fact that the federal budget and off-budget funds receive their revenues in cash form, while the regional budgets make it possible to pay taxes through offsets and barter. As a result, the regions do not have the resources to make social payments. The spending on the social sphere took up about half of all non-interest spending of the expanded budget, or 16.1% of the GDP. The structure of social expenditures was effectively unchanged therein. The percentage of the GDP for social payments (in cash form) has remained roughly constant since 1995, which testifies to the absence of reform in this area.

The next most important direction in expenditures is spending for the national economy. Despite the substantial decline since 1992, they make up 5.4% of the GDP, not counting the spending for the corresponding budgetary and off-budget funds (2.7% of the GDP). More than half of the spending for this section falls to the regional budgets, of which the bulk is taken up by subsidies for the housing and municipal sphere. A large portion of the remaining spending for the economy comprises subsidies for inefficient industrial (especially coal) and agricultural enterprises.

Spending for defense declined substantially, to 2.6% of the GDP, with a large portion of the expenditures being made in non-monetary form or in the form of offsets. On the other hand, fiscal indebtedness has currently accumulated (about 0.6% of the GDP) to finance the army. The decline in spending for defense, as with the other non-interest expenditures, occurred as a whole chiefly through the sequestering and accumulation of indebtedness. The process of restructuring those expenditures is technically further complicated by the presence of secret areas and the under-development, or often even the complete lack, of financial accounting and reporting in the army. Whereas the problem of controls on expenditures can be solved only after the transfer of recipients of funds to the treasury system is completed, the reduction of spending obligations requires that the next stage in military reform be carried out.

The spending for state administration, the security of the state, and international activity totaled about 4% of the GDP in 1999.

The total spending on the social sphere, defense, the economy, and other basic services of the public sector constitutes about 90% of the non-interest expenditures, which confirms yet again the necessity and direction for structural reforms in the fiscal sphere.

[insert Table 2, page 8]

The structure of expenditures in the federal budget and those of the regional and local budgets differs markedly.

About a quarter of federal spending in the first phase in 1999 was expenditures for debt servicing, while in the reports on the execution of the regional budgets those expenditures were lacking. So it makes sense to compare the structure of non-interest spending.

Spending on defense and other power agencies plays the main role in the functional structure of non-interest spending of the federal budget -- it was 35% of non-interest spending in 1999. Expenditures for the social sphere take a share half as large -- 17%, while expenditures for the national economy and financial assistance to the regions are roughly identical in value at 13--15%. Current spending predominates in the economic structure of the federal budget -- it constituted more than 93% of expenditures in 1998, and more than 95% of the budget in the year 2000 (not counting tied credit). The share of capital spending declined as a result of sequestering and the revocation of offsets. Their percentage of the 2000 budget is less than 5%, of which more than half was for industry and agriculture. A large percentage of current non-interest spending goes for the payment of wages (with accruals) and social transfers. They were 32% of the budget in 1998, and 37% in 2000. About a quarter of non-interest expenditures go for wages and accruals, of which more than half is monetary remuneration for servicemen and law enforcement bodies. Despite the high percentage of spending, the wages for employees in the budget-financed sphere remain low, as a consequence of which there has been an exodus of qualified personnel into the private sector. The spending on municipal services (electric power, heating) is just 3.5% of non-interest expenditures, having tripled since 1997. But the share of this type of expenditure in the accounts payable of civil budget-financed organizations is almost 50%, of which 80%<sup>1</sup> is overdue indebtedness. This could testify to the over-consumption of energy by budget-financed organizations as well.

In the breakdown of spending in sub-federal budgets, about half is spending on the economy and about 40% goes to the social sphere, of which about a third is "federal mandates," chiefly in the donor regions. In the economic structure of regional spending, a significant percentage goes to pay wages, as it does in federal spending.

However, as was already noted, the official reports regarding budget implementation do not show the true state of affairs. In order to obtain a complete picture of the Russian budget sector, it is necessary to assess spending on the basis of obligations. And some problems arise here.

It should be noted, first of all, that the budget statistics that exist as of today are quite contradictory and non-transparent. As was already noted, they reflect at best only spending executed under the procedures for the execution of budget laws. Various operations being carried out through the host of off-budget funds that have been created by some ministries and agencies, especially in the regions, are not taken into account therein.

The official statistics for the federal budget of 1999 have come to be more or less in conformity with international standards for statistics for cash implementation, although they are not devoid of some shortcomings. The situation is significantly worse in the regional budgets and off-budget funds. For example, as has already been noted, the

spending for debt servicing by regional budgets started to be taken into account only in 2000. One nevertheless cannot vouch for their trustworthiness and completeness therein. That happens for various reasons. One objective reason is the scarcity of qualified personnel. However, the main reason, in our opinion, is the striving of the regional authorities, guided by this or that motive, to conceal the true state of affairs. A host of off-budget funds are created for this purpose, through which operations related to budget operations are carried out. For example, in passing any tax receipts through off-budget funds and artificially reducing official revenues accordingly, the regional authorities can make an appeal to the federal center to increase financial assistance. Obviously, the less transparent the statistics, the greater the opportunity to conceal the true state of affairs. The federal authorities, by virtue of a number of reasons, including of a political nature, have not had any real levers for influencing the regions in this area until recently. However, efforts have been undertaken of late with regard to transferring all budgets to the treasury system of execution, which should straighten out budget operations and improve the transparency of budget statistics.

Difficulties also exist with regard to the clear-cut definition of the concept of "budget obligation." The law on the federal budget, as with the laws on the regional budgets, does not include all clear and unclear budget obligations in full.

So it is necessary to estimate the true dimensions of budget obligations and budget operations in order to analyze the budget.

Similar estimates have already been made in a number of studies, including in the works of the World Bank, the Economic Expert Group, and the Center for Statistical Developments. We will try to summarize those studies and estimates.

### *Estimate of the real magnitude of obligations in the budget sector*

The presence of budget indebtedness to budgetary recipients remains a material problem of the Russian budget. Despite some progress in this area, the problem remains topical in Russia to this day. Theoretically, indebtedness is the difference between a budget obligation and actual funding. However, taking into account the problems in defining a budget obligation, certain difficulties arise in estimating the magnitude of indebtedness. Data from the State Committee on Statistics regarding the accounts payable of budget-financed organizations are currently used to estimate budgetary indebtedness. But those statistics suffer from a whole series of shortcomings. One is based on the data, which is being sent in only by civil organizations, *i.e.* power agencies are not included here, and it is entirely probable that not all organizations are included on that list. The drawback that this information is the accounts payable of the organizations themselves, and not the budget, is even more important. Very often in practice, budget-financed organizations make expenditures over and above the limits stipulated by the budget or the Ministry of Finance, or simply make use of budget funds for other than their intended purposes. So the indebtedness that arose for these reasons cannot be considered budget indebtedness, and is not recognized by the Ministry of Finance. So for example, despite the absence of indebtedness on wages and transfers to the population for budget recipients on the part of

the Ministry of Finance, the indebtedness of civil budget-financed organizations at the federal level for those line items totaled almost 1.5 billion rubles.<sup>2</sup> According to estimates based on data from the State Committee on Statistics and the Treasury, the recognized indebtedness of the federal budget alone, including the power agencies, is currently about 50 billion rubles (8% of non-interest expenditures for the year 2000).

It is worth noting that attempts have been made at the federal level to solve the problem of arrears, and chiefly the indebtedness on wages and pensions as the most socially and politically important areas. However, those measures have been hurried in nature. The wage arrears were repaid in June of 1996 before the presidential elections, and then rose again by the end of the year to 22 billion rubles by the end of the year. The government was only able to solve the problem of federal indebtedness on wages at the beginning of 1999.

The situation was even worse in the regions. Two basic causes for this can be cited. First of all, money allocated from the federal budget was often used by the regional authorities for other than its intended purposes. Second, and probably the more important reason, the regional authorities made even broader use than federal authorities of non-monetary settlements with taxpayers. Offsets and barter in settlements with the budget led to a distortion of the structure of spending, and a lack of "real" money to finance social payments. The attempts by the federal authorities to "help" the regions through transfers and budget loans were also hurried in nature, and did not lead to the complete elimination of the indebtedness. Despite a substantial reduction in wage arrears, the problem remains topical at the regional level even today.

The problem of indirect subsidies to the economy made by the state, along with the overt subsidies that are accounted for in the budget, is also closely linked with the problem of budget indebtedness. One type of subsidy is tax indebtedness. Despite the fact that this indebtedness is revenues that have not been received, it could be considered an additional subsidy for the economy on the part of the state. Tax indebtedness is thus a form of indirect subsidizing of the economy and, consequently, indirect budget spending. Another type of indirect subsidy and source of surplus funds for the budget is the possible overstating of contract prices when furnishing services to the state. Trustworthy information on this type of spending is not available, but according to various estimates the overstating of prices for goods and services consumed by the state is from 15% to 50%.<sup>3</sup>

As has already been noted, the practice of creating off-budget funds and non-budget accounts, both at the level of federal organizations and at the sub-federal level, has become widespread. The principal reason for the creation of those funds is obviously to conceal the true amounts of budget operations. These off-budget funds are not reflected in the official statistics, but it is precisely through them that operations in significant amounts are carried out, especially at the regional level. A number of federal budget-financed organizations and other institutions with spending authority have off-budget accounts through which operations are carried out to support the leasing and other commercial activity of the organizations. The operations in off-budget accounts for

federal agencies alone for the first nine months of 1999 totaled 1.4% of the GDP. The number of off-budget funds at the regional and federal level is significantly higher. According to studies by the World Bank, there are three major off-budget funds active in Moscow alone to finance major infrastructure development projects for commercial purposes in particular. It is very difficult to estimate the total operations of regional and local off-budget funds, but a magnitude of perhaps 2--3% of the GDP seems reasonable.

The regional budgets have currently been charged with additional spending authority to finance essentially federal expenditures. These are expenditures for the maintenance, in municipal spending and wages, of budget-financed institutions that are under federal ownership or under the control of federal ministries and agencies, wages for employees in the budget-financed sphere, the financing of a number of social benefits etc. At the same time, for a number of reasons, the regions do not have sufficient funds to fund that spending. Thus, according to the most modest of estimates, the overall amount of such "federal mandates" is about 8% of the GDP, while they are funded at approximately one third.

It is also necessary to mention another important form of spending obligations of the budget that is not taken into account, or is not taken into account in full, in budget reporting. This is the indebtedness for the debts of the federal government and the debt expenditures of the regions. As has already been noted, the problem of debt servicing does not fall within the framework of this work, but these obligations must be taken into account when making an estimation of the magnitude of fiscal obligations. The indebtedness of the federal government for debt is understood to mean the non-restructured overdue payments on the foreign debt of the former Soviet Union. In view of the fact that restructuring negotiations have still not been concluded, we can only estimate that the additional burden will be at the level of 1.5--2% of the GDP. There are virtually no reliable data on the debt spending of the regions, especially because of the non-transparency of the budget statistics of the regions. Furthermore, far from all sub-federal authorities are submitting the appropriate reporting to the Ministry of Finance. According to estimates by the Ministry of Finance, the interest payments alone on the debts of the regions should constitute about 0.5--1.0% of the GDP, and with a regard for the repayment of the debt principal, 2% of the GDP.

The analysis that was done shows that the system of expenditures of the Russian budget has significant distortions. On the one hand, there are UN-financed or unacknowledged spending obligations that constitute about 9--10% of the GDP, according to estimates. On the other hand, the budgets at various levels are carrying out operations that, at least partly, go beyond the bounds of budget obligations. The volume of those operations can be estimated in the amount of about 4--5% of the GDP. The volume of the budget sphere as a whole (not counting debt servicing) can thus be estimated to be at a level of 50--55% of the GDP. Obviously, given the lack of structural reform and with a regard for the conservative macroeconomic forecasts, the percentage of the GDP in the budget sector will remain at approximately the same level in the future as well.

In a comparison with the budgets of other countries, it becomes clear that the volume of non-interest spending obligations of the Russian budget are significantly higher than the average for the Eastern European countries (41.8% of the GDP in 1995), and are roughly at the level of the OECD countries with high income levels (53.7% of the GDP in 1995).<sup>4</sup> However, the revenue levels of the Russian budget significantly lag the indicators for those countries. Whereas the revenue portion of the budget system in Russia was 35.5% of the GDP in 1999, that indicator was within the range of 40--60% of the GDP for the OECD countries in 1995, and 35--55% for the Eastern European countries. By virtue of the fact that the reserves for raising revenues have effectively been exhausted given the existing tax system and macroeconomic situation (see below), the necessity of reducing expenditures becomes obvious.

[insert Table 3, page 12]

The necessity of reforms is also confirmed by a comparative analysis of the structure of spending. As can be seen in Table 3, the structure of cash expenditures of the Russian budget differs markedly from the developed countries. The expenditures for the power agencies exceed the analogous indicators for the developed countries. The true magnitude of defense spending in Russia is significantly higher therein. The spending for housing and municipal services in Russia has declined significantly, but is nevertheless higher than in the OECD countries. But especially large differences are evident in social spending. The percentage of the Russian GDP going to spending for social needs is approximately half that of the OECD countries, especially in such an important line item as social security.

### *Revenues*

The structure of revenues in the Russian budget when it was formed at the beginning of the 1990s was aimed at ensuring stable tax receipts during a period of high inflation and drop in production. The tax system, which is the foundation of the revenue portion of the budget, was created under conditions of a lack of time for or experience in structuring tax systems under conditions of a market economy, as well as economic and political uncertainty. That structure remained fundamentally unchanged until 1999.

The bulk of revenues of the expanded budget (94%) is tax payments and deductions to social funds.

[insert Fig. 1, page 13]

The structure of the revenue portion of the expanded budget has remained roughly constant since 1995. The growth in the share of indirect taxes in 1999 is explained by the imposition of a sales tax and export duties, while the role of direct taxes rose as a result of growth in ruble revenues of the exporting enterprises that was caused by the 1998 devaluation, as well as price increases for raw materials. The share of taxes to the labor allocation, which provides 90% of the financing for social allocations, constitutes a little less than a quarter of the revenue portion of the budget.

The main component of the tax revenues is the indirect taxes -- the value added tax, excise taxes, customs duties, the tax on turnover -- which provided more than 41% of the revenues to the budget sector and about three quarters of the tax receipts of the federal budget in 1999. These taxes, as a rule, are less subject to the effects of inflation, and what is more, evading their payment is comparatively more difficult. Indirect taxes constituted 43% of the taxes in the European Union countries in 1995, not counting social deductions. That value is 58% in Russia.

The burden of the Russian tax system lies principally on large enterprises, so the predominant role of industry and transport in the sector breakdown of tax receipts is entirely natural and logical. Some 65% of the tax receipts to the federal budget, not counting customs payments, falls to the share of those sectors. The role of the oil and gas companies in 1999 was estimated to be about 25%, counting export duties. Despite the fact that the duties were imposed only in 1999, the share of those companies in the tax receipts has remained virtually unchanged since 1997, which is indirect confirmation of the poor effectiveness of taxation. The weight of the income tax in the Russian budget is much less than in the developed countries: it was 8% in 1999, compared to 40% in the EU countries. The reverse situation is seen with the tax on enterprise profits -- 15% in Russia and 10% in the EU. This testifies to the fact that the relative tax burden on enterprises is quite high, which makes using the tax system to encourage investments more difficult.

Despite the repeated statements by the government regarding its intention to shift the principal weight of taxation from enterprises to individuals, those statements have not been incarnated in reality. The reasons for that are not only the inertia and irreversibility of the system of authority and economic management, but other factors as well.

One reason is the relatively low level of income of the population in order to be able to provide revenues for the budget system. The declaration of these intentions is much less popular than attempts to extract additional taxes from major companies. The executive authorities, forced throughout their existence to fight for political survival, should have taken this factor into account.

Furthermore, it becomes obvious when analyzing budget policy in the realm of revenues in recent years that fiscal policy has taken the form of "patching holes." The government has always been forced to seek out sources of revenues and take steps that can have an impact right this minute, without having the time or opportunity to take more long-term and possibly more efficient steps. The desire of tax authorities to look for money "where it is," that is, from the enterprises, including large ones, is obvious. So the principal donors of the Russian budget, when they are broken down by sectors, are the major enterprises of industry and transport, which according to Ministry of Taxes and Fees data provide more than 60% of taxes, not counting social and customs payments.

Steps to increase revenues, including some "spot" changes in the tax legislation, have been undertaken by the Russian authorities throughout the entire period of reform. They

did not have any palpable effect, owing to their inconsistent and non-systematic nature. As a result, the revenues of the expanded budget have remained at approximately the same level since 1992 at 35--37% of the GDP, with the exception of the crisis year of 1998.<sup>5</sup>

The government, left with virtually no sources to finance the deficit or refinance state debt after the crisis in August 1998, stepped up its efforts to increase the collection of taxes in cash.

Sharp growth in tax revenues was seen in 1999-2000. This pertains to the federal budget in particular. The practice of so-called tax planning became widespread in 1999, when the tax bodies reached prior agreement with major enterprises regarding the amounts of their tax payments regardless of their tax obligations under the law, and made use of administrative levers of influence when collecting taxes. This practice, a sign of a mobilization economy, showed itself to quite effective in the short term -- budget revenues rose sharply. But it is heavily dependent on the political strength of the authorities, and leads to the rapid depletion of enterprise resources and the even greater evasion of taxes. In any case, it does not facilitate the solution of the long-term problems of the revenue portion of the budget.

However, there are also objective reasons for the rise in income. First of all, the devaluation of the ruble increased the competitiveness of the products of exporting enterprises, and increased their ruble income.

The second, and probably the more important, reason for the increase in tax receipts was the impact of increased world prices for raw materials. The high prices for oil ended up having a very positive influence on budget revenues indirectly therein. The percentage of tax revenues of the consolidated budget (about 25%) from enterprises in the fuel industry and pipeline transport has remained effectively constant since 1997, and even dropped as a percentage of the GDP despite the introduction of export duties. But the increase in revenues of the oil companies from exports allowed them to increase the monetary component when making settlements with suppliers. It was precisely this additional "real" money that probably served as the source for increasing the monetary funds in the accounts of enterprises, and their ability to pay taxes accordingly. What is more, it allowed the government to increase the export duties on oil, which markedly increased tax receipts.

### ***The principal problems of the revenue portion of the expanded budget***

All the problems of the revenue portion of the budget are currently occurring to one extent or another due to the inefficient tax system. The tax system is not handling its two principal tasks: it is not promoting economic growth, and at the same time, it is not able to provide resources to the budget.

The chronic budget deficit, even on a cash basis, has testified until recently to the inability of the tax system to perform its fiscal function. The Russian authorities tried to

resolve the problem of increasing revenues by increasing the nominal tax burden: the imposition of new taxes, a rise in already existing ones etc. However, as practice shows, the Russian economy demonstrates poor elasticity in tax receipts on changes in tax rates. The measures that have been announced to increase the collectibility of taxes have not brought real results. The stimulating factor of the tax system was the replacement of the granting of various types of concessions, sometimes unwarranted, "privately."

A host of amendments have been introduced into the tax system throughout the whole period of reform, but they have at best only solved some frequent problems under an unvarying system, and accordingly could not really change the situation.

Attempts to carry out systematic tax reform by means of adopting the Tax Code have been made repeatedly by the Russian government. However, by virtue of the fact that the proposals contained in the draft codes touched on the interests of many lobbying groups in parliament and in the government itself, the discussion and adoption of the code has constantly been dragged out or postponed. Despite this, the first portion of the Tax Code was adopted in 1998, defining the legal foundations for the tax legislation. Many sensible ideas and proposals were squandered in the process of consideration and adoption therein.

An exceedingly inefficient and distorted tax system has now taken shape. The tax burden on an average enterprise that does not have any concessions and does not conceal its operations reaches 60--70% of the added value, while the tax revenues to the budget constitute just 36% of the GDP. Despite the excessiveness of the tax burden, less taxes are collected in Russia than in the countries of the OECD: taxes, not counting social deductions, totaled 28% of the GDP in the OECD countries in 1995, while in Russia that value is less than 26% of the GDP.

The excessive tax burden, imperfections in tax legislation, and corruption within the tax and other authorities are forcing enterprises to use quasi-legal and illegal methods of existence, so the evasion of taxes is widely practiced. Thus, according to some unofficial estimates, the tax obligation of the oil companies constitutes not more than 5% of the true receipts, and not even all of that portion is being paid. About 70--80% of Russian imports are going to "gray" and "black" arrangements, and are not subject to duties. The cost of goods subject to customs and excise taxes is decreasing, and that is leading to additional losses for the budget. Only 10% of the turnover of tobacco itself falls under taxation. Pseudo-exports and tolling, leading to losses in value added tax receipts, remain a problem. The losses to the budget in the receipt of direct taxes are not subject to precise estimation.

The indebtedness on taxes and penalties, hanging like a weight on the balance sheets of enterprises, continues to grow. And no way of collecting it can currently be seen, the more so as part of it relates to enterprises that have been dissolved.

Counting primarily on receiving taxes from enterprises led to a dependence of tax shortfalls on mutual non-payments, which reinforce each other. The enterprises use the

fact of non-payments for their products to explain their indebtedness to the budget. Attempts to solve the problem of mutual non-payments by means of offsets have only led to even greater growth in indebtedness and a drop in cash receipts to the budget. Despite the fact that the percentage of cash payments to the budget has risen in recent years, it nevertheless constitutes about 40% for sub-federal budgets and 2% for the federal budget. A system of employing offsets and non-monetary forms not only introduces distortions into the structure of expenditures, but also creates incentives for enterprises to accumulate shortfalls and indebtedness, while being unfair to honest taxpayers. The federal government has repeatedly announced the repudiation of the use of offsets, but has continued to employ them in one form or another all the same. The percentage of non-monetary forms of settlement at the level of regional and local budgets is significantly higher, even though it has decreased in recent years.

A situation has thus taken shape where the tax system, while being the principal source of resources for the budget system, is not managing to handle the fulfillment of its principal functions. It is suppressing normal business activity, and is one of the main impediments to economic growth. On the other hand, it is not able to provide the budget sector of the economy with resources in the long run. At the same time, the practical attempts to make changes in tax legislation over the past few years have shown that making separate "spot" changes in the tax system is ineffective.

### **3. The principal problems of the contemporary Russian budget system**

The first conclusion from the analysis and estimation of the amount of fiscal obligations that could be cited is that the main problem of the Russian budget is the excessiveness of its spending obligations, and the gap between those obligations and the resources base as determined by revenues and other sources of financing. The financial imbalance for the federal budget alone reaches about 9--10% of the GDP. The gap between the funding for federal mandates at the regional level was estimated at 4% of the GDP in 1998. The gap for regional budgets as a whole is not less than 6% of the GDP. The overall amount of non-interest spending obligations is about 53% of the GDP. We should add to that the 8% of the GDP in obligations for servicing and repaying debts. The total spending obligations of the budget could thus be estimated at 61--62% of the GDP.

On the other hand, the resources base of the budget, according to optimistic estimates, is just 40--42% of the GDP.<sup>6</sup>

Thus the gap between the obligations of the budget and the real funding is about 19--20% of the GDP. The causes of the fiscal imbalance are, on the one hand, the excessively cumbersome and inefficient system of expenditures, and on the other, the inefficient tax system, unable to provide the budget with resources and simultaneously to perform an incentivizing function. Due to the vital necessity of a normally operating system of state finances for the country's economy, the chief goal of fiscal policy and state economic policy as a whole in the near future should be the elimination of that gap. A structural reform of the system of state finances -- both the revenue and the expenditure portions --

is essential to eliminate the budgetary imbalance, and that should indeed become the principal task of state policy.

The directions of structural reforms are determined by the problem areas in the budget system.

### *Revenues*

As has already been noted, all the problems of the revenue portion of the budget are currently occurring due to the inefficient tax system to one extent or another. The existing tax system, on the one hand, cannot provide the revenues for the execution of all the spending obligations of the budget, and on the other, creates an excessive tax burden on the taxpayers, affecting legal business activity and narrowing the tax base thereby.

In order to rectify this contradiction, it is essential to carry out a systematic tax reform and create a flexible mechanism to change the tax system in accordance with changing macroeconomic conditions, while not to the detriment of its stability therein. The basic directions of structural transformations should be the more equitable distribution of the tax burden and its reduction where possible, with a tightening of the measures of tax administration.

The reduction in the effective tax burden and leveling of tax conditions is called upon to create incentives to conduct legal business activity and pull a significant portion of the economy out of the "shadows," and ultimately to cease being an impediment to economic growth. This in turn will expand the tax base in the long run, while increasing budget revenues on the one hand and making it possible to reduce the nominal tax burden in the future on the other.

It may be affirmed that even given a favorable variation, the performance of a tax reform whose main components are the liberalization of the tax system and the reduction of the effective tax burden far from always has a positive impact on revenues. The state has lost the confidence of the population that it had at the beginning of the reforms in recent years as a result of poorly thought-out and inconsistent policies. So a palpable impact from tax changes could appear only in two--three years, provided there is stability and consistency in the pursuit of tax and other structural reforms.

### *Expenditures*

The problems of state spending have several levels.

The first (structural) level consists of the cumbersome and inefficient structure of budget obligations. These problems can accordingly be solved only by carrying out structural transformations in the budget sphere and the economy as a whole.

An inefficient structure has taken shape in virtually all spheres of the budget sector: social expenses, the subsidizing of the economy, national defense etc. The solution of

problems at this level goes beyond the framework of fiscal policy, and requires the pursuit of structural reforms in the corresponding areas. Budget policy, or more precisely the resources base of the budget, is just one of the constraints that define the allowable size of budget obligations.

Thus, the reduction and consolidation of social obligations is impossible without the pursuit of structural reform in the social sphere. On the one hand, the role of social spending in Russia is significantly lower than in the developed countries. On the other hand, there is evidence of their inefficient utilization and the excessive "generosity" of the state in relation to the population. The system of social security and support for the population of Russia includes a significant number of social guarantees, benefits, and payments that may be enjoyed by about 70% of the population.<sup>7</sup> Only a quarter of the total benefits go to households with an average income below the minimum household subsistence level therein.<sup>8</sup> The reasons for that are that the bulk of the benefits are granted on the basis of the categorical principle, rather than according to the level of need. So it is essential to reform the system of social security in the direction of increasing the targeted nature of the social support being provided. The elimination of benefits to well-off families will make it possible to reduce budget spending and/or raise the amount of social payments and benefits to families truly in need.

The system of pensions also needs to be reformed. At the end of 1999, the average pension was less than 80% of the minimum subsistence level for a retiree.<sup>9</sup> On the other hand, according to demographic studies, the population of Russia is "aging." This means that if the pension system remains unchanged, its resources base will decline. In order to avert a crisis in the pension system, it is essential to reform it, and in particular to make the transition to an accumulative system while making broader use of the practice of providing pensions through non-state pension funds.

The situation is analogous in other areas of social policy as well: medical care, education, the realm of culture and the arts. At the same time, the effective functioning of the system of education, culture, and medical care, impossible without normal pay and pension levels, is strategically important for the country. One way of solving this problem without increasing spending could be a reduction in the number of employees in the budget-financed sphere with an increase in the pay for the rest, which will require the structural reform of the whole budget sphere.

We can single out two directions for strategic reform in the area of spending in support of the national economy. First is direct and indirect subsidies to enterprises. As has already been noted, enterprises are subsidized by the budget not only directly, but also indirectly through the granting of tax concessions, deferments, or simply the accumulation of tax shortfalls. Solving this problem, aside from the creation of a consistent state policy in the area of subsidies, requires the pursuit of institutional reforms of enterprises (and broader use of the mechanism of bankruptcy in particular), tax reform, and the solution of the social problems of employees at enterprises being dissolved. The obligations of the budget therein should also include such spending as financing for basic scientific research

and the subsidizing of agriculture, since those areas cannot be financed on the basis of self-sufficiency.

One example of inefficient spending on the economy that could be reduced without any visible negative effects is tied credits. This is foreign non-financial credit (deliveries of equipment etc.) that is furnished by foreign government or international financial organizations to enterprises and organizations under a *de facto* guarantee of the federal government. The recoverability of that credit is about 15%, and it is being utilized far from fully and is not leading to any rise in the efficiency of production, while increasing state foreign debt therein.

Accordingly, another problem and area of structural transformations is the subsidizing of housing and the municipal sphere. The subsidizing of municipal payments of the population is currently taking place out of the local budgets in some regions. Despite some of the cutbacks that have been made, as has already been noted those expenditures currently take up about 2.8% of the GDP and 20% of spending of the consolidated budget of the regions. The share of those expenses is significantly higher in some regions. A system of cross subsidies for the population by the enterprises has taken shape in this sector. Given the prevailing situation in the housing and municipal sphere, the excessive spending burden is borne by the local budgets and enterprises that are subsidizing the population. On the other hand, the concessions on payments for municipal services are enjoyed by poor and well-off households to an equal extent. An analogous situation has taken shape in other areas of social services as well, for example public transportation. The reform of housing and municipal services and the social system is essential to solve these problems. We need gradually to shift the burden of spending from the budgets and enterprises to the population. We need to introduce a differentiation of the amounts of payments by the population depending on income levels, and where necessary create a system of targeted assistance for needy households.

The problem of the structure and distribution of spending among budgets at various levels is quite acute as well. The problem of inventorying and distinguishing spending authority (mandates) between the federal and regional budgets currently requires resolution. This pertains first and foremost to the spending authority for financing some social expenditures. After the authority of the budgets at various levels is clearly delineated, it will be possible to determine the degree of centralization of the budget system and the structure of financial assistance to the sub-federal budgets and off-budget funds.

Defense spending continues to be a substantial problem for the budget, and something of a "black hole." As has already been noted, the amounts of state spending on defense are the most difficult of all to estimate due to secrecy considerations. According to various estimates, defense spending ranges from 2.6% of the GDP<sup>10</sup> to 11.4% of the GDP.<sup>11</sup> But the efficiency of that spending can be assessed as quite low. Judging by the reports that have become accessible to the public, the extent to which the armed forces are being equipped with new types of weapons is declining, the wages of servicemen are too low, and the defense industry is the chief generator of budgetary indebtedness. The reduction

in military spending and rise in its effectiveness requires the further reform of the army and the defense system.

The next level of problems with the spending portion of the Russian budget consists of the presence of an inefficient system of management for state finances, and in particular the absence or insufficiency of tight controls over the utilization of allocable resources. The insufficient controls over the utilization of the budget funds was one of the causes of the accumulation of accounts payable in budget-financed organizations, which could now prove to be a substantial burden to the budget in addition to the existing obligations.

The problem of the use of budget funds for other than their intended purposes will be resolved in the process of converting all budget recipients to the treasury system of budget fulfillment. Most of the budget recipients at the federal level, along with some regional budget recipients, have now been converted to that system.

#### **4. The effects of structural reforms on the budget**

The principal problem of the Russian system of state finances is the imbalance between spending obligations and the budget revenue base. The income and expenditure portions of the Russian budget are in need of radical reform therein. The elimination of budgetary imbalance should be the aim of fiscal policy and the economic policy of the state as a whole in the foreseeable future. Analysis shows that this goal can be achieved not only and not so much through measures of fiscal policy, as it could by the pursuit of profound structural transformations in the Russian economy.

It is not only the spheres pertaining directly to the budget -- tax policy, the social sphere, the system of state management, defense etc. -- that should be subject to structural reforms. The economy and state finances cannot function without the pursuit of broader institutional reforms and the formation of effectively operating institutions in such areas as the judicial and legal systems, the protection of property rights etc.

In view of the complexity and social sensitivity of these reforms, it is quite difficult to assess their impact on the system of state finances. It may be asserted with a certain degree of confidence that we should not expect any appreciable positive impacts in the short term, the more so as a great deal depends on the form the structural transformations end up taking. But the very fact of the implementation of reforms will give a definite signal to the economy regarding the readiness and resolve of the government to take a constructive approach to the resolution of accumulated problems. Provided there is stability and consistency in the reforms being pursued, as well as given relatively favorable macroeconomic factors, definite positive changes in the budget system could be expected as soon as in two to three years, for example, in tax policy. But the overall improvement and revival of state finances should take a longer period of time -- not less than 5--10 years.

Significant qualitative changes should occur within the structure of the budget as well, provided these conditions are met. The structure of tax revenues will to all appearances

remain the same for two or three years. Accordingly, the role of direct taxes will most likely increase in the event steady economic growth begins, with increased profitability for companies and a rise in population incomes. The share of indirect taxes could decline somewhat, both through the displacement of direct taxes and through the predicted decline in nominal rates, for example, for the value added tax.

It is much more difficult to predict the structure of expenditures. It may be stated with a certain degree of confidence that spending on the economy will decline as a result of the elimination of overt and concealed subsidies for some organizations that had previously been subsidized. With regard to the remaining non-interest expenditures, it is quite hard to say. The most important thing here, as has already been noted, is to consolidate all the indirect obligations of the budget and the off-budget operations of budget-financed organizations and authorities, and then optimize them and cut them back.

Given the successful pursuit of reforms, the budgetary imbalance will decline, chiefly through expenditures. The reasons for that are, on the one hand, the excessive nature of the expenditure portion of the budget, and the need to reduce it while improving the efficiency of management. On the other hand, there is little potential to raise the share of revenues in the GDP and the overall thrust of a reduction in the tax burden. Finally, an absence of budget deficits, *i.e.* the making of additional borrowings in amounts that do not exceed debt repayments, will be an essential condition of macroeconomic stability for the next 5--10 years by virtue of the presence of a substantial debt burden. So the size of the Russian budget in the ten-year perspective can be estimated to be at the level of 40--42% of the GDP, which is below the lower limits of the budgets in the OECD countries.

## **5. Conclusion**

The structure of the Russian budget and the entire budget system has been subject to marked changes during the years of reform. But it becomes obvious in more profound analysis that these changes have been quite superficial in nature, and have not touched on many of the problems that have been inherited from the command-administrative system, and the more so have engendered a whole series of new shortcomings that are slowing or blocking the development not only of the budget system, but the entire economy as well.

The chronic failure to fulfill the budget, the accumulation of indebtedness, the absence of effective controls on budget funds etc. have caused the state to lose the confidence of the population as an important resource for the pursuit of reform.

The current favorable condition of state finances should not mislead us -- it is effectively being sustained on the high prices for oil, which is an unstable factor. This "well-being" could and should be used to carry out structural transformations in the budget system of Russia as the basis for the functioning of the state.

The question of the optimal size of the stage budget of Russia is still a topic of debate. But an analysis of the Russian budget sector shows that there are substantial reserves to reduce and optimize it.

The measures of macroeconomic policy are not able to rectify the shortcomings and distortions of the budget system in Russia. The necessity of pursuing structural reforms in the budget sector has become acute.

The required structural reforms go beyond the framework of fiscal policy, and should touch on both economic and other aspects of life, such as legal and judicial reforms, military reform, the reform of the social sphere etc.

It is obvious that reforms will require unpopular steps to be taken. But Russia has no other choice in the long term, or even in the medium term. The sooner and the more resolutely the authorities carry out the reforms, the sooner and more painlessly the economy and the population will adapt to the new conditions.

### Footnotes

1. According to State Committee on Statistics data as of December 1, 1999.
2. According to State Committee on Statistics data as of January 1, 2000.
3. Report from the World Bank, *Basic Approaches to Analysis of the State Spending of the Russian Federation*, 1998.
4. Report from the World Bank, *Basic Approaches to Analysis of the State Spending of the Russian Federation*, 1998.
5. However, it should be taken into account that the percentage of "real" money rose significantly over this period through the federal budget: whereas in 1996 the level of non-monetary tax revenues of the federal budget was 3.6% of the GDP, in 1999 just 0.2% of the GDP was coming in the form of targeted financing. But the use of offsets and other non-monetary forms remains a problem at the regional level.
6. The current tax revenues of the budget are 35% of the GDP; non-tax revenues are 1% of the GDP (up to 3% of the GDP in the long run, provided the efficiency of utilization of state property improves); borrowing in the amount necessary to repay the debt principal to maintain a zero deficit is 4% of the GDP. Estimates from the Strategic Developments Center were used in the calculations.
7. According to data from the Strategic Developments Center.
8. According to data from the Strategic Developments Center.
9. According to data from the Strategic Developments Center.
10. Official reporting of the Main Administration of the Federal Treasury.

11. Arms Control and Disarmament Agency, United States (taken from the World Bank report, *Basic Approaches to Analysis of the State Spending of the Russian Federation*, 1998).