



## **Russia: Bank Assistance for Public Sector Management and Governance**

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## Acronyms

BEA	Bureau of Economic Analysis
CAE	Country Assistance Evaluation
CAS	Country Assistance Strategy
CASE	Center for Social and Economic Research
ECA	East and Central Asia Region
EDI	Economic Development Institute
ESW	Economic Sector Work
FFRRL	Fiscal Federalism and Regional Fiscal Reform Loan
ICR	Implementation Completion Report
IDF	Institutional Development Fund
IET	Institute for the Economy in Transition
IFI	International Financial Institution
IMF	International Monetary Fund
IT	Information Technology
NGO	Non-governmental organization
OED	Operations Evaluation Department
PAR	Performance Audit Report
SAL	Structural Adjustment Loan

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## Preface

This paper is one of the background papers prepared as an input to the Russia Country Assistance Evaluation (CAE, Task Manager, Gianni Zanini) by the Operations Evaluation Department (OED) of the World Bank. Findings are based on a review of project appraisal and completion reports, sector reports, and a number of other documents produced by the borrower, the Bank, and research papers in the academic literature. Mr. Baran Tuncer interviewed Bank staff at headquarters. An earlier preliminary version was discussed at a small workshop in Moscow in February 2001, with participation of central government officials, academics and members of policy research institutes, and representatives of project implementation units of Bank-supported projects. Their valuable assistance and feedback is gratefully acknowledged.

This review covers areas of on institutional reforms that have a bearing on the way the public sector operates and public resources are managed in the whole of the economy. This means that institutional changes in individual sectors are outside the focus of this paper. Therefore, sector specific loans and economic and sector work related to individual sectors have not been included in this review.

Mr. Baran Tuncer (a professor of economics at Bilgi University, Istanbul, Turkey; former Cabinet Minister in 1974-75 and Director of Economic Planning Department in 1964-66 in Turkey; senior, principal, and lead economist in the World Bank during 1980-1994). He incorporated some of the findings contained in preliminary, individual drafts on the same subject prepared separately by Mr. Sergei Drobyshevsky (a researcher at the Department of Macroeconomics and Finance, Institute for Economy in Transition (IET)), and Mr. Jan Anthony Vincent Rostowski (a professor of economics at Central European University, Budapest, Hungary), Center for Social and Economic Research (CASE), and himself into this paper.

The authors are grateful for the comments received on previous drafts by the OED peer reviewer (Mr. Anwar Shah), CAE task manager and other team members, external CAE advisory panel members (Gur Ofer, Leonid Polishchuk), ECA staff (Carlos D.C. Ferreira, Friedrich Peloschek, Robert J. Anderson and Misha Belkindas), which have been taken into account in the June 2001 version. However, the views expressed in this paper remain entirely those of the authors. They do not necessarily represent the views of the World Bank.

An earlier draft dated June 29, 2001 was sent to the Russian Government for review. Comments were received from Mr. L. I. Yakobson, a consultant engaged by the Federal Centre for Project Finance (FCPF) on behalf of the Government, and are attached as Annex 4 to this paper.



## Executive Summary

1. Since the Russian Federation joined the Bank in 1992, the assistance strategy with respect to public sector management has evolved considerably. In the early years, fiscal management, capacity building, and institutional development in the public sector, as well as good governance received little attention by the Bank, adversely affecting its potential contribution to Russia's transition.

2. Lack of emphasis on public sector management and governance both in analytical studies and lending operations may be attributed to a number of factors: (a) the approach taken by the Bank to all transition economies; (b) the paucity of information and analysis on the Russian system; (c) the high turnover of senior and middle level administrators in the government; and (d), until recently, the reluctance of the officials to engage the Bank in such issues.

3. As far as the lending program is concerned, the two quick-disbursing rehabilitation loans in 1993 and 1995 did not incorporate any public sector management issues. Even though the main focus of the three following Structural Adjustment Loan (SAL) operations, starting in 1996, was not the public sector, they did incorporate policy conditionality for improvement in tax administration, budget management, and intergovernmental finance. However, the implementation of these policy loans fell short of expectations. The Bank has approved five sector projects to date to support capacity building in specific areas such as tax administration and legal reform. The selection criteria for these projects were rather arbitrary and did not conform to a clearly articulated assistance strategy. The relevance of the majority of these projects is relatively high; it is still difficult to assess their efficacy at this early stage.

4. Economic and sector work that relates to public sector management issues was not well balanced until recently. Emphasis was mainly on intergovernmental finance. A number of studies focused on tax-related issues. However, the serious problems of nonpayments and of sustainable public debt dynamics did not attract much attention until after 1997. A number of critical areas such as civil service reform, expenditure planning, and governance were either bypassed or understudied. This gap in the Bank's knowledge in such crucial areas had a negative impact on the Bank's ability to advise the government on the restructuring of the size and role of the public sector and improving of the quality of public expenditures and services. This void is gradually being filled now.

5. However, there has been a noteworthy shift in the Bank's attitude, particularly since the 1998 financial crisis. The Bank began to see its involvement in Russia from a longer perspective. A stronger emphasis was given to capacity building in the public sector. Issues such as reform in public administration, civil service, judicial system, revenue and expenditure management, and governance have received a higher level of attention. This has coincided with the changing attitude of the new government. The Russian authorities now pay more attention to reforms in the public sector, and are actively seeking Bank support in areas once considered sensitive. On request, the Bank has prepared a number of concept or position papers to support the government's

initiatives in modernizing and streamlining public administration. Current economic and sector work covers topics such as public investment review, anti-corruption, and federal budget management, and is supportive of the enlarged lending program. The Bank's proposed lending includes relatively large projects on treasury development, regional fiscal reform, tax administration modernization, and customs reform. The size and the diversity of this program are commensurate with the recent emphasis given to public sector issues.

6. Clearly, institutional development in the public sector and good governance are at the core of Russia's transformation to a market economy. The Bank today seems to be better positioned to meet the challenge than in the past and should reinforce its recent initiatives. If the government does not backtrack, as it often did in the past, Bank assistance can make a useful contribution. The next Country Assistance Strategy (CAS) should fully reflect the emphasis on public sector issues and governance. A focused lending program, further economic and sector analysis, and policy dialogue addressing the key issues should complement this.

# 1. Country Assistance Strategy for Public Sector Management

## Early years

1.1 Bank strategy with respect to public sector management and governance issues has evolved considerably over the years. At the outset, the Bank's overriding objective was to facilitate the transition to a market economy based on private initiative and ownership. Even though the Bank was aware that such an economic transformation presented difficult challenges, some fundamental problems Russia faced were overlooked. Because the "new state" did not have proper control of its borders, had a monetary system in which the relations between the dozen or more central banks in the ruble zone were still not settled, and had a tax system that was totally unsuited to a market economy, it did not receive sufficient recognition. Issues that relate to public sector management, including capacity building, institutional development, and governance received little attention in the early period of Bank involvement in Russia. Also, relatively little stress was laid on the extent to which macroeconomic stabilization was central to the success of the envisaged transformation of the economy.

1.2 The first formal CAS of 1993 identified the areas that required primary attention: setting up a functioning price system, private sector development, enterprise reform and restructuring, financial sector reforms, trade reforms, and the expansion of the social safety net. The need to overcome structural weaknesses in the public sector was not on this list of priorities. Nonetheless, the 1993 CAS observed that the legal framework for property rights and conflict resolution, which was essential for healthy private sector development and for attracting foreign capital, was missing in Russia. Also mentioned was the need to strengthen the institutional capacity of local and regional governments. This latter area was a recurring theme in subsequent CAS documents.

1.3 Insufficient emphasis on public sector management and governance was also apparent in the succeeding 1994 CAS, 1995 CAS, and the CAS Progress Report of 1996. The 1994 CAS was prepared in an environment of failing macroeconomic stabilization, and the weakening resolve for reforms. This was reflected in the Bank's choice of projects that could still succeed in such an environment. A greater emphasis was placed on inter-budgetary relations, because of regions assuming more responsibility as the spending authority was being transferred to regional and local level administrations, particularly in the social sectors.

1.4 The 1995 CAS recognized once again that the Bank was unable to expand its program because of "institutional instability" in the country. The report did indicate that the development of public sector institutions and procedures supportive of open, competitive markets was important. Nonetheless, when it came to specifics, only the need to develop an independent judiciary was mentioned. The 1996 CAS Progress Report pointed to the close association with the International Monetary Fund (IMF) to develop a comprehensive agenda of structural reforms, which included, among others, reforming intergovernmental fiscal relations and tax administration.

## **Bank strategy since 1997**

1.5 The Bank's assistance strategy to the Russian Federation has placed increasingly more emphasis on reforms in the area of public sector management since 1997. The 1997 CAS pointed to problems inhibiting the development of the private sector, including crime, corruption, noncompetitive access to business premises and urban land, lack of a legal framework for secured lending, difficulties in contract enforcement, and arbitrary practices of tax and customs authorities. It went on to reiterate the actions undertaken by the government in the area of better governance, such as in fiscal management, expenditure realignment, improvement of the treasury system, and consolidation of some off-budget operations.

1.6 The 1997 CAS also pointed out the inadequacy of these actions and emphasized the importance of further reforms in this area. Coinciding with the return of the reformers to the government, the Bank gave a stronger focus to the rationalization of the tax structure, improvement in tax administration, strengthening of budget management, and reforming intergovernmental fiscal relations. The 1997 CAS indicated that the Bank would participate in high priority institution building programs, including legal reform, even though such projects in the past had not been very successful. It is also important to note the activities of Economic Development Institute (EDI) in Russia in knowledge dissemination, training, and institution building. EDI participated actively for the first time in the preparation of a CAS in 1997. It was also decided that EDI would work closely with the Region in capacity building and knowledge dissemination.

1.7 By 1998, the Bank was increasingly concerned about the lack of policy direction and commitment to reforms, as well as efficiency and transparency in the use of public resources. Eventually, the August 1998 financial and currency crisis and the change of government that followed led to widespread backsliding, not only on macroeconomic stabilization and meeting domestic and international obligations but also on structural reforms. In the document entitled 1998 CAS Progress Report, an "interim operating plan" was presented, in which the need to strengthen public resource management was strongly emphasized. Moreover, improvements in this area were cited as prerequisite to additional sector lending.

1.8 After the 1998 financial crisis, the government began to demonstrate more interest in Bank's support and assistance in certain areas of economic management. These included improved policy analysis capability for economic reform, strengthening of debt management, and improvement of national income statistics.

1.9 In late 1999, the latest CAS was presented, which gave considerably more emphasis to public sector management and governance. The Bank's evolving strategy for Russia assistance reiterated the fact that institutional barriers and capacity limitations in the public sector were inhibiting growth and economic transformation. Reforms in the administrative structure of the government, civil service, judicial system, and revenue and expenditure management had to be expedited. More pointedly than before, the corruption issue was highlighted. Corruption was perceived to be widespread and deep rooted. It

was undermining efforts in economic management and public sector administration. Strong and determined political leadership was needed. Strengthening the capacity, transparency, remuneration, and independence of public service was essential. According to the 1999 CAS, it was also important to improve the management of public resources, remove unnecessary discretionary interventions in the market, and build a strong judiciary.

1.10 The Bank's strategic priority called for a phased shift in emphasis in favor of reform of "systemic policies" and institutions to improve the performance of the public sector. To further this point, the CAS document stated that the Bank "would increasingly emphasize public sector reforms, with direct support to the private sector limited to guarantees against regulatory risk." This was followed by a number of important initiatives in the Bank in support of government policies and programs, as outlined below in this note.

1.11 In January 2001, a progress report on the country assistance strategy was sent to the Board. The report reiterated the focus of the Bank Group assistance program on systemic and institutional reforms, and renewed emphasis on strengthening public sector institutions and accountability. The CAS Progress Report stressed the importance attached by the Bank to the government's 10-year economic development program. Most of what had been agreed upon with the Bank in the context of now-defunct SAL III is now part of the government's program, and the criteria for Bank assistance is now changed to the government fulfilling its own program.

## **2. Lending Operations and the Public Sector**

2.1 Capacity building and institutional development in the public sector are addressed in the context of both sector projects and adjustment lending. However, there has not been an umbrella project addressing the shortcomings of the public sector as a whole, such as public administration or civil service reform. Some details of the individual projects are given in Annex 2 of this report.

### **Sector specific loans**

2.2 Sector specific loans addressed capacity building in individual sectors or institutions. In the past, five sector projects were approved by the Bank's Board. They are the Tax Administration Modernization Project, Legal Reform Project, Bureau of Economic Analysis Project, State Statistical System Project, and Regional Fiscal Technical Assistance Project. The total loan amount for these five projects is \$157.4 million, which is equal to about 1.7 percent of the total loan commitments to the Russian Federation. This is a very small percentage, given the relative importance of the institutional development and capacity building needs of the Russian public sector. However, as will be explained later, there is a relative increase in the loan amounts earmarked for public sector development under the current lending program.

2.3 *Tax Administration Modernization Project* (Fiscal Year [FY] 95-\$16.8 million). The overall objective of this project was to support the modernization efforts of the State Tax Service (STS), which was created in November 1991. STS faced organizational and procedural problems, had inadequate processing capacity, and lacked adequately trained staff. The project would help build the infrastructure, mainly through providing computer equipment needed to collect and process tax revenues effectively and facilitate capacity building. The project focused both on the central body of the tax service and two regions as pilots. Improvements in tax administration included rationalization of organizational structures, study and training programs for staff, and the establishment of divisions to deal with large taxpayers within the territorial tax offices. To improve business processes, measures were taken to enhance the quality of interaction with taxpayers, to improve procedures for the identification of tax offenses, to introduce a taxpayer identification number system, and to centralize data processing.

2.4 The tax administration project ran into implementation difficulties from the beginning. In fact, the Bank was ready to cancel it after four years. However, during the last year, the government showed renewed interest in the project. With some mutually agreed changes in coverage, the government was able to complete the implementation of the project, which closed end-December 2000.

2.5 The main accomplishments under the project were: improvements in the tax administration system, technical modernization of the regions that took part in the project, and increase in discipline in the conduct of tax-related matters. Progress was achieved in tax collection in the pilot regions only in the last phase of the project. Even though 80 percent of the funds under the project were earmarked for the procurement of hardware and software, institutional impact of the project was also measurable.

2.6 Recent project status reports rated the achievement of development objectives “satisfactory.” The region now considers the project one of the most successful in the Bank’s Russia portfolio.

2.7 *Legal Reform Project*. (FY96-\$58 million) The Bank has been concerned with the inadequacy of the Russian legal system in effectively protecting private property and providing a secure environment for investment. The shortcomings of the system manifested themselves in imperfect legislation, law enforcement practices and institutions, and citizens’ lack of awareness of their legal rights and obligations. The judicial system has been plagued also by the low authority of the overwhelming majority of judges, a low level of juridical education, current application of a negative selection mechanism (through qualification commissions), and low-level compensation. While the need for legislative and legal reform was emphasized as early as in the 1993 CAS, the preparation and approval of the Legal Reform Project had to wait until FY66. The project components included improvements in legal drafting, establishment of a system for the codification of legal information, legal education and public education campaigns, and judicial reform.

2.8 Under the circumstances, computerization of the courts' component of the project should be expected to have only limited impact. Provision of computers to insufficiently trained legal staff, by itself, is unlikely to have an impact on verdicts rendered by the court. Within the framework of the project, grants provided for the development of higher judicial education is likely to accomplish more. The project also funded publication of social advertising and manuals. While it is difficult to measure the effectiveness of advertising, publications for the legal enlightenment of schoolchildren were inferior to those funded by other sources such as the Youth Center for Human Rights.

2.9 The implementation of this four-year project was slow in the early years, mainly due to resistance from the legal profession. However, in the course of last year the project implementation improved considerably. Recent project status reports give "satisfactory" ratings for implementation progress and for achievement of development objectives. Upon the government's request the loan has recently been extended until end-June 2002.

2.10 *Bureau of Economic Analysis Project.* (FY97-\$22.6 million) The principal objective of the project was to help the government build institutional capacity for sound economic analysis in support of market-oriented structural reforms. The project is financing policy studies, capacity building in the Bureau of Economic Analysis and in the core economic ministries, and improvements in national accounts. At the beginning, the wisdom of setting up a new institution was questioned. Some thought that upgrading existing institutions would have been more appropriate and efficient.

2.11 Recent project status reports rated implementation progress and the achievement of development objectives, as "satisfactory." According to these reports, Bureau of Economic Analysis (BEA) policy studies have been of good quality and were well received by the ministries and other government agencies using them, as well as the Russian and international academia. The staffing of the Bureau has been in accordance with the plans. After a slow start, improvement of the national accounts' component of the project has recently been accelerated. However, there is an issue with the institutional capacity building objective, since it is not clear if the government will fund the BEA activities in full after the closing of the project. The closing date of the project is September 2003.

2.12 *Statistical System Project.* (FY99-\$30 million) Even though the government has taken initiatives in the past to improve macroeconomic statistics, problems remained with quality of data, coverage, and accounting standards. This project was designed to strengthen institutions involved in data collection and compilation. In particular, GOSKOMSTAT is the main beneficiary of the project. The project experienced delays at the outset due to procurement-related concerns, the resolution of which was expected not to take long. Based on such expectations, implementation progress and achievement of development objectives were rated "satisfactory" in recent project status reports. The project implementation is in its early stage, and only 3 percent of the funds have been disbursed, as of March 2001. The closing date of the project is end-June 2004.

2.13 Earlier, an Institutional Development Fund (IDF) grant in 1994-95 supported capacity building in GOSKOMSTAT, with good results.

2.14 *Regional Technical Assistance Project.* (FY2000-\$30 million) The project aims to build institutional capacity for advancing reform of the intergovernmental fiscal relations and to improve fiscal performance at subnational level. Its components include federal and fiscal legislation, federal monitoring capacity, accounting and budgeting practices, and sectoral public expenditure reviews. The loan was declared effective end-August 2000. Recent project status reports give “satisfactory” ratings for project implementation and achievement of development objectives, particularly noting the relatively strong client ownership. This is considered a well-designed, and, so far, well-executed project. Its successful implementation is important also because it will lead to a large project loan to support subnational governments in the fiscal area, as will be described later in the text. The project is scheduled to close at end-December 2004.

2.15 Currently, a number of public-sector-related projects are under preparation or planned. These projects will be reviewed in the following section.

### **Rehabilitation and Adjustment Loans**

2.16 These loans were designed to support the transformation process in Russia, and, in the process help the government by sharing the cost burden of adjustment, while providing much-needed foreign exchange. To date, two rehabilitation and three structural adjustment loans have been implemented

2.17 The First (FY93-\$600 million) and Second (FY95-\$600 million) Rehabilitation Loans were approved in FY93 and FY95, respectively. Both loans addressed structural reforms considered important for a successful transition to a market economy. They covered areas such as enterprise reform, trade policies, financial sector reform, price system and pro-competition measures. The first loan was to support the 1992 comprehensive reform program of the government aimed at the far-reaching liberalization of the economy. The second loan was more of the same thing. However, by June 1992, the political “window of opportunity” for reform had already closed and reforms were being pushed back. Although intended to support government efforts, neither of these projects made specific reference to public sector management and governance issues. This was very much in line both with the Bank’s strategy and the government’s agenda of reform at the time, neither of which emphasized public sector restructuring.

2.18 Both of these loans have been closed and evaluated. While ECA’s Implementation Completion Reports (ICRs) rated both project outcomes “satisfactory,” the OED rating of the first project was only “marginally satisfactory,” and the second one “unsatisfactory.” These evaluations were moot regarding whatever impact these projects might have had on the public sector.

2.19 The First Structural Adjustment Loan or SAL I, (FY97-\$600 million) supported actions in four areas: reform of natural monopolies, private sector development, and fiscal reform and banking. The two succeeding operations maintained a similar focus in actions supported. Capacity building in the public sector was included to the extent of improving tax administration, strengthening budget management, and reforming intergovernmental fiscal relations. In the area of tax administration, the authorities had already adopted measures under the Revenue Action Plan. SAL I was to support the expansion of this plan, as well as the efforts to improve expenditure control and budget management. Also, under SAL I the government developed a work program to reform tax sharing and transfer arrangements with the subnational governments. In the area of tax administration, special attention was paid to identification of large tax dodgers, elimination of offsets on tax arrears, and introduction of accelerated bankruptcy procedures in the event of existing overdue tax arrears.

2.20 Under the SAL framework, the Bank staff provided technical support in key areas of reform. In addition to the specific areas formally covered under the project, some capacity building was accomplished in the Treasury, and a system of regular monitoring and reporting on expenditures was introduced.

2.21 This single-tranche loan was closed in March 1998. The Region's ICR review rated the outcome of the project "satisfactory," while the OED review gave an "unsatisfactory" rating. Institutional development impact was rated "partial" in ICR, and "modest" by OED, in essence the same ratings, only different in name. OED's main point was that there was too much emphasis on formulation of action plans and not enough on implementation. Also, there was insufficient impact of reforms, including those in the fiscal area. According to a draft PAR report, significant progress was made in restructuring the expenditure side of the budget, including the installation of a treasury system for all ministries except defense. On tax reform, however, little progress was made. The report gave a "moderately unsatisfactory" rating for the outcome of the project. Institutional development impact on the whole was rated "modest." The "rapid quality at entry" assessment rating for the "institutional capacity aspects" was "satisfactory."

2.22 The Second Structural Adjustment Loan or SAL II, (FY97-\$800 million), which was also a one-tranche operation, had a similar agenda. To improve tax administration, the authorities took additional steps to broaden reforms in the procedures and management of the State Tax Service and the Customs Committee. The government committed itself to establishing large taxpayer units in eleven regions, in addition to the five that were already set up. Improvements were made towards strengthening the expenditure management system to bring budget execution in line with budget preparation, and to align actual spending with intended outcome. Towards rationalization of government spending, revisions were made in public procurement procedures. The government made progress in introducing a computerized treasury system of accounting. The social extra-budgetary funds were included in the budget. A number of further steps were taken to improve intergovernmental fiscal relations.

2.23 Against the “satisfactory” outcome rating by ICR, the OED review found the project outcome “unsatisfactory.” The shortfall observed in the implementation of reforms, including the fiscal measures, was the main reason for such a low rating. Ratings for institutional development impact were similar; “partial” in ICR, and “modest” in the OED review. The draft PAR graded the outcome of the loan “moderately unsatisfactory,” and the institutional development impact was “modest.” “The quality at entry” assessment rating of this project for institutional development was “negligible.”

2.24 The Third Structural Adjustment Loan or SAL III, (FY99-\$1.5 billion) was the largest of the three. To improve tax administration, the government was to amend the tax code and restructure the federal, regional and local government STS offices. Reforms were to continue to reduce the number of extra-budgetary funds. To further improve budget management, the government was to move all federal agencies into the Federal Treasury. The government was to reduce civil service employment by 200,000 and build a strategic program for administrative reform. Reforms in Intergovernmental fiscal relations would be enacted through legislation. A unified debt reporting structure would be established.

2.25 SAL III, which was a three-tranche operation, was cancelled in August 2000, only after the first tranche was disbursed. The government found that SAL III was too broad in coverage and too detailed and complex, as well as having too ambitious a timetable. The “quality at entry” assessment of this project gave a “marginal” rating for both overall assessment of quality and the institutional aspects.

2.26 In summary, unlike the two earlier rehabilitation projects, the three succeeding structural adjustment operations did incorporate some elements of public sector management and capacity building. Gains were made in the areas of expenditure restructuring and, to a lesser extent, reforming the system of taxation. The main causes of fiscal imbalance were identified correctly. They included a weak tax discipline, a growth in arrears, the barter of transactions, the use of offsets, and the insufficient control of budget expenditures. However, in the course of implementing the public finance management reform, particularly in the field of rationalization of expenditure, a serious obstacle was lack of political consensus in the country. Policy advice and technical assistance rendered in the context of SAL operations were considered helpful by the authorities. All in all, these policy loans clearly did not succeed in inducing the government to undertake most reforms, nor did it help prevent the 1998 crash. Implementation fell short of expectations in all reform areas, including the anticipated fiscal reforms.<sup>1</sup>

2.27 Once again, it is important to note that the Bank’s policy loans did not go far enough to cover central issues of public sector management and capacity building, such

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<sup>1</sup> Gur Ofer, one of the members of the external advisory panel for the Russia CAE, agrees that the problem was more on the revenue side and not with expenditures. He wonders, however, to what extent this was in the interest of a political coalition of the new “managerial banker elite” with the tacit participation of some reformers and Yeltsin, who opted for a smaller budget and lower taxes.

as civil service reform, reform and reorganizing of the public sector, and governance. Therefore, an important window of opportunity was not sufficiently utilized.

### **3. Economic and Sector Work**

3.1 In the early years of Bank's involvement in Russia, economic reports and studies were relatively scarce. The earliest work on Russia was a three-volume study, "The Economy of the USSR," which was completed in 1991, with a number of International Financial Institutions (IFIs) contributing. The report described the ills of the Soviet economy and recommended a strategy for transformation, which put emphasis on macroeconomic stabilization, liberalization, and enterprise restructuring, in that order. Since then there has been a growing body of reports and other documents on Russia covering various aspects of the economy, highlighting the issues, examining the institutions, and making recommendations. These studies take the form of economic reports, policy research working papers, internal discussion papers, technical papers, and fiscal policy notes. In this note, only those studies relevant to public sector management issues and capacity building in the general sense have been reviewed. A brief summary of each of these economic and sector reports is given in Annex 3 of this paper.

3.2 Studies on public sector management have focused mainly on intergovernmental finance and subnational fiscal issues, taxation and tax administration, and more recently on budgetary issues. The Bank's economic and sector work on intergovernmental finance issues has been extensive. These studies covered a wide range of issues including: federal transfers, subnational budgeting, decentralization of regional fiscal systems, fiscal sovereignty, intergovernmental revenue sharing and the division of revenues from natural resource taxes, disparities among the regional budgets, and decentralization of expenditure planning responsibility. Their findings have underscored the importance of subnational fiscal issues, a more efficient allocation of public resources, an effective system of fiscal federalism and improved regional fiscal management in achieving the objectives of economic growth, good governance, and poverty reduction. Most studies made recommendations for implementation. In particular, the groundbreaking Wallich study of 1994 is noteworthy, since it has influenced the authorities' thinking on intergovernmental finance more than the other studies.

3.3 Studies on fiscal management in the Russian Federation pointed out that the budgets grossly misrepresented revenues and outlays. Recommendations were made for more detailed public expenditure analysis. To date, however, no thorough analysis of public expenditures has been completed. Recommendations were also made on how to improve and strengthen the budgetary processes. One such study—"Budget Management in the Russian Federation"(1998)—provided input for the budget discussions in the Parliament. A few of the studies examined the system of taxation both at central and subnational levels and indicated the strong need for reform both in policies and in the tax administration. Recommendations were made to strengthen tax administration by improving staff training, computerization, and tax audit capacity. However, the serious

problems concerning nonpayments, and sustainable public debt dynamics did not attract much attention until after 1997.

3.4 Even a cursory review of the existing economic and sector reports in public sector related issues reveals an uneven distribution among different areas. By far the greatest emphasis was on intergovernmental fiscal issues. However, until recently, this interest was not reflected to the same degree in the CAS, much less in lending. Meanwhile, there is no convincing justification for the nearly total neglect of some important areas in economic and sector work, particularly in early years. As a result, a number of crucial issues such as public expenditure review, public administration, civil service, and governance were overlooked for a good part of the period under review. This is not entirely surprising, given the fact that institutional development and capacity building in the public sector received very little attention during this time.

3.5 The lack of emphasis on the public sector was also reflected both in the Bank's policy dialogue with the authorities. The fact that these areas have been considered sensitive by the Russian authorities explains partly the paucity of studies in these fields. However, it was more a reflection of the little attention paid to public sector development by the Bank. Regardless of the cause, however, this has left a big gap in the body of knowledge and understanding in some crucial areas, not only by the Bank, but also by the government and other Russian stakeholders.

3.6 There has been a change in the emphasis given to public sector issues in economic sector work (ESW), in recent years. The current ESW will be reviewed in the following section.

## **4. Current Bank Assistance**

### **Recent developments**

4.1 As far as the Bank's involvement in public sector issues is concerned, relations with Russia appear healthier and more productive today than in the recent past. There has been a marked change in government's attitude with respect to Bank's involvement in areas once considered sensitive. This has coincided with the increased awareness of the importance of public sector management issues and governance in the Bank. It appears that the Bank has a much better chance now to make a more meaningful contribution to the reform process in the public sector of Russia. For this to happen, it must be willing to invest sufficient human and budgetary resources to produce high quality and comprehensive inputs to the budgeting process, and to ongoing debate in the country on PSM reforms.

4.2 The administration of President Putin has demonstrated awareness that Russia needs to modernize and streamline its public administration. This is partly because the new president desires to strengthen the state in general. In July 2000, a comprehensive ten-year economic development program was put forward. Prominent in this strategy is a commitment to restructuring the executive, legislative, and judicial branches of the

government at both the federal and regional levels. In December 2000, the President instructed that a working group on public administration be created. Similar attempts in the past were usually short lived, but the current signals are more encouraging.

4.3 The Bank has indicated that its support of the government's initiatives in this area would be of three kinds: technical assistance, ESW, and knowledge management. Technical assistance would support the government's ability to produce formal programs of action. ESW would help build the analytical base of support by the Bank. Knowledge dissemination would try to build medium-term consensus behind the emerging agenda for reforms. On this basis, there is an ongoing dialogue with the authorities on several public sector issues, including reforms in public administration, tax policy, budget management, public investment planning, and anti-corruption policies.

### **Lending program**

4.4 Compared with the earlier years, the Bank now has a larger program for lending in the public sector with an emphasis on capacity building and institutional development. In FY02, two sector projects are being proposed: the Treasury Development, and the Fiscal Federalism and Regional Fiscal Reform Loan (FFRRL). The success of these operations depend a great deal on the quality and readiness of specific relevant agencies to fully own the programs and projects, and become real partners. Therefore, while the prospects for successful implementation of these and similar projects are now higher, one still needs to proceed with caution in anticipating outcomes.

4.5 The Treasury Development Project, at \$400 million, would be the largest Bank operation ever undertaken for Information Technology (IT) system development and installation. Its main objectives are to ensure effective budget implementation, to enable the Ministry of Finance to maintain budget oversight, and to provide a transparent system of accounting of the resources used. The project will assist in the goal of improved macroeconomic management and address key system weaknesses leading to increased vulnerability to corruption. The importance of development of the Treasury was emphasized in the Bank's 1966 report on "Fiscal Management in Russia," which provided a broad review of priorities in fiscal management. The proposed project, with an implementation period of six years, will provide technical assistance, computer equipment, software, and training. A recently held Quality Enhancement Review on this project, despite some risks, found the project basically sound.

4.6 The proposed FFRRL is a four-year, \$120 million, policy-based, sectoral adjustment loan. The main purpose of the project is to assist the government in meeting the transitional cost of implementing its program for strengthening the overall framework of fiscal federalism and improving fiscal management at the regional level, with a view to achieving greater fiscal stability, improved service delivery, and better governance. In the Russian Federation, the relations between the federal government and regions are highly complex and politically difficult. The government's program supported by this loan aims to restructure the system of fiscal federalism so that both the federal and regional governments have clear responsibilities, sufficient financing and an incentive to

pursue sound fiscal management. The precursor of this four-tranche loan is the ongoing Regional Fiscal Technical Assistance Project, which lays the groundwork for this project, and helps build institutional capacity for it.

4.7 In FY03, currently two projects are proposed: the second Tax Administration Modernization Project (TAMP II) and the Customs Reform Project. The objective of TAMP II is to promote a sustainable revenue collection system through improvements in the level of taxpayer compliance, while promoting increased efficiency and professional ethics, and reducing taxpayer compliance burden. Tax administration remains weak with uneven regional revenue collection, and significant tax arrears, even though the government has taken strong steps for improvements in tax administration in the past. The government now plans to embark on a comprehensive program to address the main remaining issues. The proposed five-year, \$130 million TAMP II is conceived as a project to support the authorities in these efforts. There is some likelihood that this project may be moved forward to FY02.

4.8 The second FY03 project on customs administration would, in a way, complement the tax administration project and would cover systems, processes, and capacity building in customs management. Even though it is not formally included in the lending program yet, there is some talk regarding the inclusion of a judicial reform project in FY03, which would also incorporate anti-corruption measures. And, finally a civil service reform project may be undertaken in FY04. The much talked about SAL IV, which would have picked up some of the unfinished reforms in the public sector, is shelved at the moment. The interest of the government in a relatively demanding project seems to have diminished because of the economy's lessened need for foreign exchange.

4.9 The size and the diversity of the present lending program indicate a strong push for institutional development and capacity building in the public sector. This is entirely appropriate, given that for an orderly transition of the economy, Russia needs an effective public sector and good governance.

### **Box 1: Taxation vs. Budget Restructuring**

Putting the Russian public sector on sure footing and making it more adaptable to the needs of society requires a major improvement in public sector finances. In reality, chronic deficits in the budget turned out to be a problem of the postcommunist economy. Relatively low tax collection against the background of high government spending helped perpetuate the high budget deficits. High levels of tax arrears of the enterprise sector contributed to this outcome in a major way.

The government and the IFIs, including the World Bank, have put more emphasis on the augmentation of tax revenue to deal with the budgetary shortfalls. Attempts, particularly in the 1996-98 period, to increase the political and administrative pressure on economic entities to pay their tax obligations did not stick. The lingering political instability was the main reason.

Throughout 1995 and 1998 attempts have been made to improve tax collection through improving the system of tax administration and tax legislation. The authorities made extensive logistical and political efforts to improve collection of taxes such as declaring campaigns to combat tax arrears, expanding the function and authority of the tax service, promoting the director to a cabinet minister's post and later on to vice premier. However, all these and other measures produced limited results and after a short while tax collections went down to former levels. This is not to deny the significance of tax reform. However, the objective should be not just to raise the level of collection for the sake of resolving the budget crisis, but rather to make the system more just and, at the same time, to make it more neutral and conducive to avoid distortions over the system of relative prices and accumulation of savings. The tax reform of 2000-01 contains serious changes in this direction.

More emphasis should have been put by all those concerned (the government and IFIs, including the World Bank) on reducing the size of expenditures, as well as restructuring them. This, of course, is a painful issue both from a social and political standpoint. While the ratio between government expenditures and gross domestic product (GDP) has been on the decline since 1992, the pace was painfully slow. Also, under pressure from the various lobbying groups, the structure of expenditures has become more irrational. The populist policies of the opposition parties that had a majority in the State Duma encouraged all types of expenditures. Under such circumstances, improvements in tax administration and collection could hardly reduce the budget deficit, as increased revenue would likely translate into higher expenditures voted in subsequent years.

Nonetheless, it has been more and more obvious that the evolving structure of government spending was conducive to maintaining neither economic growth nor a desirable level of social and political stability. More than once, the cabinet attempted to improve the process of budget appropriation in the federal and local governments. A number of government resolutions have been passed, particularly since 1998, to limit government spending and to improve its structure. However, no lasting solution has been accomplished and the problem continues.

(Extracted from the IET paper on Public Sector Management)

### **The ongoing and proposed economic sector work**

4.10 A number of initiatives have already been taken by the Bank recently to strengthen the analytical base in public administration and to support the government's program for reform. In response to the growing concern about corruption, an interim report on Corruption in Russia was prepared in June 2000. The report put emphasis on three forms of corruption: policy capture, administrative corruption, and judicial capture. While administrative corruption was typical of the region, the impact of political and

judicial captures was very high. The paper's conclusion was that the problem of corruption is deeply entrenched and that anti-corruption strategy centering only on enforcement is not likely to succeed. Instead it would be appropriate to combine enforcement with policy and institutional reforms aimed at increasing transparency and accountability in the public sector, introducing greater competition in the private sector, and strengthening the capacity of civil society to help with the design and implementation of anti-corruption reforms. An Anti-corruption Diagnostic Study is part of the FY01 ESW program. The study includes a survey to be carried out by the INDEM, a Russian non-governmental organization (NGO). However, the survey does not appear to be progressing as scheduled.

4.11 A Public Investment Review is underway that would support the government's efforts to increase the effectiveness of public investments with the 2002 budget. The main objective of this study is to develop recommendations for institutional strengthening and policy changes, where applicable. This is the first in-depth review of public investments in Russia, covering both the federal budget and, to the extent data allow, subnational budgets. The previous work on this subject—"Investment Policy Report" in 1995, "Budget Management Report" in 1996, and "Benchmarking Public Expenditure Work" in 1999—were more general and had limited coverage of public investments. The Bank is also providing technical support to the Ministry of Finance on public expenditure analysis in connection with the 2002 budget preparation, mainly in the context of the other donor-financed projects. Meanwhile, under the ongoing Regional Fiscal Technical Assistance project, regional, sectoral, public expenditure reviews are progressing in six regions.

4.12 Another piece of ESW scheduled in FY01 is the "Federal Budget Management Review," which is under preparation. The Bank puts strong emphasis on this study because the issues that are undertaken are intimately related to the large Treasury development project scheduled for FY02. The Region feels that Treasury development without strengthened expenditure planning and budget management would not be as productive and effective. In this context, reform in budgetary institutions, including the process of budget formulation, is considered a high priority. Earlier efforts to engage the authorities in a dialogue on such agenda met with limited interest. However, work on the Treasury development project is likely to encourage the government to be more forthcoming.

4.13 In addition, at the request of the government, notes have been prepared on public administration reform, including: the experience of 14 selected countries in this area; the scope of civil services in OECD and Central and Eastern European countries; and a background note on comparative government pay and employment data. Policy notes are being prepared on budgetary issues. A study on pension reform is also under preparation. The Region is likely to undertake two studies on tax policy next year. One of these will be examining the scope for increasing tax revenue from national resource rents; and the other will be on payroll tax. These studies are expected to contribute to the 2003 budget.

4.14 All these make up a timely and well-diversified ESW on public sector issues. The studies support the lending program for the next few years. It is also important that topics such as civil service, corruption, public expenditure, and investment reviews, once almost off-limits for study, are now incorporated in the ESW.

## 5. A Summary Assessment

5.1 **Early Bank strategy did not give priority to the public sector.** Up to 1997, Bank's strategy did not assign any priority to institutional development and reform of the public sector. Bank's engagement in public sector management issues was limited to few areas, as reflected in the studies undertaken and the lending programs of the earlier years. During this period, intergovernmental finance, the legal system, and tax administration attracted more attention than other areas of institutional development and governance. Glaringly missing on the agenda were vital public sector issues such as civil service, public expenditure planning, and corruption, as well as public administration in general.

5.2 **Many factors contributed to this lack of attention.** Inadequate attention paid to public sector issues in the Bank's strategic thinking in the earlier periods may be attributed to a number of factors. The most important reason is likely the Bank's overall approach to the transformation of transition economies in the early 1990s. The conventional wisdom then was that transformation to a market economy could best be accomplished by price liberalization and privatization of state-owned enterprises. This was evident not only in the assistance strategy to the Russian Federation, but also in all East European and Central Asian countries. Only in recent years has there been an awareness of the extent of structural changes needed for the transformation of these economies, and the central role played by the government in this process.

5.3 Second, knowledge regarding how the government in the Russian Federation operated and how the weaknesses of the system could best be tackled was scarce. Also, the number of experienced staff on public sector issues such as civil service and governance was few. As more specialized staff were recruited, the findings of various economic and sector work emerged, experience from the lending operations grew, and public sector and governance issues began to receive higher priority.

5.4 Third, the reluctance of the government to engage the Bank in public sector and governance issues had an impact. Moreover, the lack of coherence in the administration and frequent turnover among key staff in Russia discouraged dialogue. Even after the Bank became more aware of the damaging impact of poor governance on the effectiveness of economic policies, the government seemed to resist the Bank's involvement. It is only recently that the Russian government seems to be seeking the Bank's support on a number of important initiatives in public sector reform.

5.5 **Insufficient attention to the public sector affected the lending program, ESW, and the Bank's overall impact.** Whatever the reasons for the lack of involvement in the public sector of Russia, they have adversely affected the Bank's potential impact on the

economy. Until recently, very important public sector issues were left out of the economic and sector work. This has caused a large gap in the Bank's body of knowledge and a lack of appreciation for the seriousness of the current state of the public sector and weak governance in Russia.

5.6 As expected, this lack of attention to the weaknesses displayed by the Russian public administration influenced the lending program. The two earlier rehabilitation projects did not involve the public sector issues. As far as the following three adjustment operations are concerned, their preparation was rushed to transfer financial resources to the country. Reforming of the public sector was not a priority with these operations, even though some issues of the sector were incorporated in the design.

5.7 Five sector loans that were made to address the reform needs of different institutions were not part of an agreed upon overall strategy for institutional development or capacity building in the public sector. The choice was often influenced by the positions taken by public officials in Russia. In hindsight, it is evident that these projects did not enjoy sufficient government ownership at the outset.

5.8 **Bank strategy has evolved since 1997 with respect to the public sector.** After 1997, the Bank's strategic thinking regarding the importance of the reform in the public sector has changed considerably as evidenced in the CAS documents, and to a lesser extent in ESW and lending program. The change in the Bank's approach to public sector management issues has become even more evident since 1999. Capacity building in the public sector, institutional development, more effective management of public resources, and governance are now given a higher priority. There is more accumulated knowledge and experience in the Bank regarding not only the Russian economy but also all transition economies. And the Region is now better staffed with specialists in public sector and institutional development.

5.9 **The attitude of the government is also changing.** There has also been some change in the attitude of the Russian government. To make the state stronger, the leadership in Russia has publicly announced the importance attached to reform and modernization in the public sector. Moreover, it now seeks the Bank's support in technical assistance and loans in some crucial areas of public administration, and in achieving better governance. Frequently, the authorities ask the Bank for specific studies in these areas; and on issues once considered too delicate to involve the Bank, the government now appears seriously interested in its advice and contribution. There is a dialogue now between the government and the Bank on such key issues as public administration reform, change in the organization of the government, civil service reform, and even corruption.

## 6. Conclusions and Recommendations

6.1 Until recently, the Bank's treatment of the public sector issues in strategy documents, lending operations, and economic and sector work was clearly inadequate. This was partly because of the lack of understanding of the problems confronting the country at the outset, but the challenges involved in the transition to a private sector oriented market economy were also underestimated. This is understandable, since the Bank did not have the experience and accumulated knowledge to deal with the problems of the transition economies. As a result, the Bank approached the problems of Russia, as well as the other transition economies, in the same way as it did other developing countries. Mass privatization and price decontrol were chosen as the main mechanisms for transition.

6.2 Meanwhile, more serious problems faced by the country were and still are those that relate to governance, corruption, law and order, and ineffective public administration. Without making major strides in these areas an equitable and sustainable growth may be an illusion. In the past, intentionally or not, the Bank shied away from these thorny issues. Large policy loans did not address the existing problems in these areas, nor were they fully effective in the areas they did address.

6.3 The Bank is often criticized for being "soft" on Russia, transferring large sums of money to the country in the past without binding conditions, or overlooking the lack of government ownership of the programs it supported. This was partly because the bilateral donors put pressure on the Bank to provide quick disbursing loans to back the reformers and their policies in the country. However, the bilateral donors themselves did not put much emphasis on the importance of good governance and properly functioning public administration.

6.4 It should be evident by now to all those concerned that institutional development and capacity building in the public sector, as well as improved governance, are at the core of Russia's transformation to a fully-functioning market economy. The Bank now is better positioned to meet this challenge. In fact, in recent years, the Bank has accumulated considerable knowledge and experience regarding governance and corruption in postcommunist countries. It should exploit its comparative advantage in this area. Now, there seems to be another "window of opportunity" to make an impact on crucial public sector issues, since the government appears more predisposed to communicate with the Bank in those areas once considered sensitive. If the government maintains its stated commitment to public sector reform and continues to welcome Bank involvement, the Bank could make a valuable contribution to improvements in public sector management and capacity building, as well as to governance.

6.5 To facilitate this process, the Bank's next CAS should fully reflect the importance attached to institutional development and capacity building in public sector development. This should be complemented by a lending program, economic and sector work, as well as policy dialogue addressing the key issues in this area. However, it is extremely

important in the Russian context that the strategy for public sector development must go beyond “public finance management” and incorporate the elements of public administration and civil service, as well as anti-corruption and good governance. Without major improvements in these areas, other developmental objectives would be hard to realize. Reform in public administration, however, should not encourage a bigger state, and broader controls for this would defeat the purpose of good governance.<sup>2</sup>

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<sup>2</sup> Leonid Polishchuk, another member of the external advisory panel for the Russia CAE, makes a number of complementary comments, summarized as follows: (a) Design and implementation of public sector reform programs did not properly reflect the institutional dynamics of the Russian transition. The early neglect of public sector development was predicated on the implicit assumption that good governance would be brought about by grassroots demand from the nascent private sector. Instead, the public sector has developed chronic pathologies, most notably corruption, red tape and the failure to protect property and contract rights, and impartially enforce rules and regulations. (b) It is therefore essential for future public sector programs to be preceded by thorough stakeholder analysis that would identify likely beneficiaries that could be agents for change, and possible sources of opposition and sabotage. (c) Particular attention should be given to the implementation of proposed programs, sequencing of their components, and mechanisms by which promoted changes will get broadly accepted and sustained. (d) Reforms in the public and private sector should be coordinated with each other. (e) Civil society should also impose checks and balances, demanding transparency and accountability of the government and making sure that the energy of the current push to “strengthen the Russian state” is spent on streamlining public administration and eliminating corruption and theft, rather than resurrecting an authoritarian rule. (f) An important aspect of public sector reform is proper solicitation of local inputs. Specifics should be developed with active participation of Russian experts.

## Matrix of Public Sector Management Issues

### Country Assistance Strategy

<i>Fiscal Management, Tax and Customs Administration</i>	<p><u>CAS 1993</u>: Revised approach to intergovernmental fiscal relations suggested.</p> <p><u>CAS 1997</u>: Further reforms emphasized for improved tax administration.</p> <p><u>CAS 1999</u>: Strengthening institutions for revenue and expenditure management, as well as reforming intergovernmental fiscal relations proposed.</p>
<i>Legal and Judicial Systems</i>	<p><u>CAS 1993</u>: Legal framework called defective.</p> <p><u>CAS 1994</u>: Legal framework needed to be expanded.</p> <p><u>CAS 1995</u>: Independent judiciary emphasized.</p> <p><u>CAS 1997</u>: Bank assistance strategy called “legal reform high-priority institution building.”</p> <p><u>CAS 1999</u>: Strengthening the legal system is priority.</p>
<i>Public Administration</i>	<p><u>CAS 1997</u>: Civil service reform needed.</p> <p><u>CAS 1999</u>: Reforming the administrative structure of the government and civil service system required.</p>
<i>Others</i>	<p><u>CAS 1997</u>: Strengthening debt management important.</p> <p><u>CAS Review 1998</u>: Bank would support the country debt management issues.</p> <p><u>CAS 1999</u>: Governance and corruption issues were brought to focus.</p>

### Lending Operations

<i>Fiscal management, Tax and Customs Administration</i>	<p><u>Tax Administration Modernization Project (1995)</u> (To modernize tax administrations in two regions, capacity building in tax administration.)</p> <p><u>SAL I</u>: (Improving tax administration, strengthening budget management and expenditure control, and improving system of intergovernmental relations.)</p> <p><u>SAL II</u>: (Reforms in the STS and the Customs Committee. Reform public procurement procedure. Strengthen budget management system. Reforms in intergovernmental fiscal relations.)</p> <p><u>SAL III</u>: (Restructuring federal and regional STSs. Reducing the number of extra-budgetary funds. Further strengthening of budget management and the Treasury. Legislating for intergovernmental fiscal relations. Strengthening debt management capacity.)</p>
<i>Legal and Judicial Systems</i>	<p><u>Legal Reform Project 1996</u> (To support improvements in legal drafting, improve legal education, systemize legal information. Encourage judicial reform.)</p>
<i>Public Administration</i>	
<i>Others</i>	<p><u>Bureau of Economic Analysis Project (1997)</u> (to finance policy studies, increase capacity for economic policy analysis in the Bureau of Economic Analysis and in core economic ministries, and improve national accounts.)</p> <p><u>State Statistical System Project (1999)</u> (To strengthen Goskomstat institutionally, strengthen and assist other data collection agencies.)</p> <p><u>Regional Fiscal Technical Assistance Project (1999)</u> (to strengthen federal and fiscal legislation, strengthen federal monitoring capacity, assist subnational governments in accounting and budgeting, support sectoral public expenditure reviews.)</p>

## Economic and Sector Work

<p><i>Fiscal Management, Tax and Administration</i></p>	<p><u>Intergovernmental Fiscal Relations in the Russian Federation</u>, (1992). The paper addresses the issues of fiscal sovereignty and natural resource taxation.</p> <p><u>Fiscal Decentralization, Studies in Economics of Transformation</u> (1992). Covers intergovernmental fiscal relations and sharing system, expenditure assignments.</p> <p><u>Russia and the Challenge of Fiscal Federalism</u> (1994). Team work examining fiscal decentralization and intergovernmental fiscal relations.</p> <p><u>Decentralization and Fiscal Disparities Among Regions</u> (1994).</p> <p><u>Budget Coverage and Government Finance in the Russian Federation</u> (1994).</p> <p><u>Transformation of the Regional Fiscal System in Russia</u> (1994).</p> <p><u>Towards Medium-term Viability</u> (1995). Economic Report focusing mainly on fiscal adjustment, tax Administration, and inter-budgetary relations.</p> <p><u>Fiscal Management in the Russian Federation</u> (1995). Economic Report covering the budget system.</p> <p><u>Budget Management in the Russian Federation</u> (1998). A fiscal policy note looking at federal budget management issues.</p> <p><u>Intergovernmental Transfers Reform in the Russian Federation</u> (1999). A fiscal policy note.</p> <p><u>Benchmarking Public Expenditure Analysis in the Russian Federation</u> (1999). A fiscal policy note Providing a road map for further public expenditure analysis. Also covers the issues in civil service reform and defense expenditures.</p> <p><u>Decentralization of Regional Fiscal Systems in Russia</u> (1999). A policy research working paper examining intergovernmental fiscal relations within regions.</p> <p><u>Subnational Budgeting in Russia</u> (1999). Looking into reforms at the subnational level</p> <p><u>Russia's Transition to a New Federalism</u> (2001). The study examines the dynamics of decentralization, expenditure responsibilities, revenue assignments, transfer systems, and reform implementation.</p>
<p><i>Public Administration</i></p>	<p><u>Russian Economic Reform, Crossing the Threshold of Structural Change</u>(1992). This CEM underscores the importance of public administration including the role and structure of central administration and staff training.</p>
<p><i>Other</i></p>	<p><u>Corruption in Russia</u>, (2000), The report distinguishes different types of corruption with an emphasis on the impact of policy and judicial capture</p>

## Public Sector Management in Projects

### Sector Lending

#### **Tax Administration Modernization Project (\$16.8 million)**

**February 15, 1995**

Shortcomings of the tax administration in the Russian Federation are well documented. Improvements in the collection of a number of taxes, particularly value added tax and profit tax were considered to be essential. The State Tax Service (STS) was created in November 1991. However, STS faced organizational and procedural problems, inadequate processing capacity, and lack of adequately trained staff.

With the assistance of the IMF and other donors, the STS developed a plan to modernize the tax administration. The project was to support the implementation of this three-phase plan, implementation of which had begun in 1992. The project was to create the infrastructure needed to collect and process intended tax revenues effectively. The specific objectives were to (a) modernize tax administration in two regions through reorganization of the structures and procedures, automation, and staff training; and (b) assist in the institutional development of tax administration through capacity building in the STS and helping with the nationwide implementation of tax administration reforms.

The IMF was actively involved in the preparation of the project, and supported its implementation with technical assistance.

#### **Legal Reform Project (\$58 million)**

**May 21, 1996**

The Russian legal system is inadequate for the flourishing of a market-oriented private sector development. The legal system does not effectively protect private property, defend economic rights against infringement, or establish a secure environment for investment.

The objective of this project was to improve the performance of the Russian legal system in areas key to the effective functioning of market institutions. Project components were to support (a) improvements in legal drafting, (b) establishment of an appropriate system for classification and codification of legal information, (c) conducting of legal education and public education campaigns, and (d) improvements in judicial reform and alternative dispute resolution.

#### **Bureau of Economic Analysis Project Loan (\$22.6 million)**

**May 14, 1997**

As the reform agenda grew more complex, capacity constraints in economic analysis became more acute. For Russia to implement more extensive structural reforms, it had to overcome weaknesses in government procedures, including establishing reasonable civil service salaries and incentives for quality. Also, policy analysis provided to government lacked analytical objectivity, while macroeconomic data were not reliable enough for sound analysis.

The principal objective of the project was “to build institutional capacity for sound economic analysis in support of market-oriented structural reforms.” The project was to finance (a) policy studies, (b) efforts to increase capacity for economic policy analysis in the Bureau of

Economic Analysis and in the core economic ministries, and (c) improvement of national accounts.

**State Statistical System (STASYS) Project (\$30 million)**  
**April 16, 1999**

Changes in the economy posed challenges to the major data collection and compilation issues for the statistical systems. While the government has taken several initiatives to improve macroeconomic statistics, problems remain regarding the quality of data, coverage, and accounting standards. The purpose of the project was to eliminate data gaps for economic policy and management, capture new activities, introduce international standards, increase efficiency of relevant agencies, and improve the quality of analysis and monitoring.

The project was designed in three parts: (a) institutional strengthening of GOSKOMSTAT, (b) technical assistance to data collection agencies, and (c) project management. All three components were addressing capacity building and institutional development.

In the same area, a 1994-95 project, financed with the Bank Institutional Development Fund, also aimed at strengthening institutional capacity of GOSKOMSTAT in the area of national accounts (GDP figures, data collection, dissemination, etc.) The project, which was financed with grant funds, was completed in 1995.

**Regional Fiscal Technical Assistance Project Loan (\$ 30 million)**  
**November 30, 1999**

The principal objectives of the project were to “build institutional capacity for advancing the reform of the intergovernmental fiscal relations and improving fiscal performance at the subnational level.”

The project had four components. They were (a) strengthening of federal and fiscal legislation, (b) strengthening of federal monitoring capacity, (c) assistance to subnational governments in accounting and budgeting, and (d) reviewing sectoral public expenditure at subnational level. The project is expected to improve the legal framework of subnational public finance and intergovernmental fiscal relations. This would lead to sounder fiscal and economic policies in the long term. The loan is now fully effective, but the effectiveness date of this project was pushed forward to September 2000, because of the government’s delay to fulfilling prior conditions.

**Rehabilitation and Structural Adjustment Loans**

**Rehabilitation Loan (\$600 million)**  
**July 22, 1992**

The loan would provide foreign exchange to finance imports needed in support of Russia’s program of stabilization and economic reforms. Reforms that were singled out in the loan document were enterprise reform, pro-competition and anti-monopoly policies, foreign direct investment, financial sector reforms, and social safety net establishment. The project did not make specific reference to public sector management issues.

**Second Rehabilitation Loan (\$600 million)**  
**May 15, 1995**

The loan aimed to support the Government's program for macroeconomic stabilization, as well as an agreed program of structural reforms. These reforms included trade policies, oil export procedures, pricing and pro-competition measures, and other actions including access to commercial real estate, and restriction to the use of Federal Employment Fund for transfers to enterprises. The project document did not make direct reference to public sector management issues.

**Structural Adjustment Loan (\$600 million)**  
**May 16, 1997**

The main objective of the project was "to assist the government to undertake the reforms necessary to lay the foundation for renewed economic growth." SAL gave priority to reforms that would "contribute most directly to the resumption of growth and maintenance of macroeconomic stability." Actions in four areas were chosen for monitoring: (a) reform of natural monopolies, (b) private sector development, (c) fiscal reform; and (d) banking reform. Issues covered under the fiscal reform heading are more closely related to public sector management. They included (a) rationalizing the tax structure, (b) improving tax administration, (c) strengthening budget management, and (d) reforming intergovernmental fiscal relations.

The SAL document observed that Russia's tax structure was complex and distorted, which made legal compliance difficult and encouraged evasion. The authorities had already taken measures to broaden the tax base and increase collections. Moreover, the government had submitted a new draft Tax Code to the Duma, which included more substantial changes in the structure. SAL required further amendments to the current draft before its passage into legislation.

Development of an efficient and impartial tax administration was the second objective. The SAL I document observed, "the tax administration was over-burdened with complex filing procedures, weak collection and audit procedures, and with under-skilled and over-decentralized staffing." The authorities had already adopted measures under the Revenue Action Plan to strengthen tax administration. SAL I expected the expansion of this plan.

The third objective was to bring budget execution in line with budget preparation through improvements in budgeting management systems and processes. The government had limited capacity to control actual spending, while the financial reporting and accounting frameworks remained inadequate. All these deficiencies resulted in the accumulation of large budgetary arrears. The government had already taken measures to improve expenditure control and budget management. SAL incorporated further steps to strengthen efforts in this area.

The fourth area of fiscal reform was the system of intergovernmental fiscal relations. The government had already submitted comprehensive legislation to the Duma, regulating subnational government borrowing. Under SAL, the government was to finalize a work program to reform tax sharing and transfer arrangements.

SAL I was a single tranche operation. By mid-May of 1997, all prior actions for circulation of Board documents were implemented. SAL I was approved and became effective in

June. Under the SAL framework, the Bank staff provided technical support in the key areas of reform. In addition to the actions supported in all major policy areas, some capacity building was accomplished in the treasury, and in introducing a system of regular monitoring and reporting on expenditures. Support has also been given to improve procurement procedures in line with international practices. The loan was closed in March 1998.

**Second Structural Adjustment Loan (\$800 million)  
November 28, 1997**

SAL II was presented to the Board in November 1997 as a two-tranche operation. The project was to support actions in the same areas as the previous SAL, as well as actions in the area of trade policy reform.

While the government appeared keen on a major tax reform, the Duma decided to send the Tax Code for a new first reading. SAL II expected that the Tax Code would become effective, as assumed in the draft 1998 budget. The government was to launch training for federal and regional officials in the application of the Code. Towards the improvement of tax administration, the government would “undertake broad-based reforms of procedures and management of the State Tax Service and the State Customs Committee.” The government was to establish and make operational large taxpayer units of the Federal State Tax service in five regions, and committed itself to establishing such units in 11 other regions by end-1997. The Revenue Action Plan would serve as a basis for actions to be taken in tax administration in the remainder of 1997 and the medium term.

Another objective of fiscal reform program was to strengthen the budget management systems and processes. This would be crucial for bringing budget execution in line with budget preparation and aligning actual spending with intended budget outcomes. Towards the rationalization of government spending, a presidential decree was issued in August 1997 to reform public procurement procedures. Other measures included the introduction of competitive tendering for all grain and food procurement; and the acceleration of reforms in the housing sector with a view to reducing subsidies.

Improvements in fiscal management also involved the reforming of intergovernmental fiscal relations. It has been recognized that the current intergovernmental fiscal relations were too expensive and inefficient. The government had set up a commission to develop a reform program to improve the system. The completed new draft laws were to provide a legal framework for intergovernmental tax revenue sharing. Further steps were identified for the improvements in intergovernmental fiscal relations.

The loan was closed end-1998, after being totally disbursed.

**The Third Structural Adjustment Loan (\$1.5 billion)  
July 26, 1998**

*SAL III was the third and last adjustment operation.* With a loan total of \$1.5 billion, it was the largest of the three SALs. Unlike the first two operations, the loan was to be disbursed in three tranches.

In SAL III fiscal management was again one of the four areas of reform. Under fiscal management the areas covered included: reforming the tax structure; improving tax

administration; reform of extra-budgetary funds, strengthening budget management; reforming intergovernmental fiscal relations; and debt management and monitoring. To improve tax administration, the government was to take steps to overcome some of the shortcomings of the system through amendments in the Tax Code and by restructuring the federal STS and the STS in regional and local government offices. Reforms were to continue in reducing the number of extra-budgetary funds. Important steps had been taken in the past over the processing and control over disbursements of budget funds parallel to the strengthening of the Treasury. To further improve budget management, the government was committing itself to moving all federal agencies fully into the Federal Treasury. Also, the government was to reduce total civil service employment by 200,000 positions and to build a strategic program for administrative reform.

Under reforming intergovernmental fiscal relations, fiscal-federal reforms would be scheduled through reformulated legislation or amendments of existing legislation. The government would reformulate the legal basis for revenue and expenditure assignments at each level of government. The current system of federal transfers was also to be basically restructured. To strengthen capacity for debt management and monitoring the government was committed to developing a unified, debt-reporting structure. Also, the government would initiate implementation of an integrated, public, debt-monitoring system. SAL III was cancelled in August 2000, after less than one third of the loan total had been disbursed.

## **Economic and Sector Work on Public Sector Management**

### **Russian Economic Reform (Crossing the Threshold of Structural Change), 1992**

This is the first Country Economic Report written on Russia. After discussing the roots of the macroeconomic crisis faced by Russia, the report discusses the reforms needed to overcome the crisis and pave the road for transition to a market economy. Systemic reforms were needed in the enterprise and financial sectors, labor market and social safety net, and transitional trade and payment arrangements. Sectoral reforms were discussed in the context of energy, agriculture, environment, infrastructure, and housing.

The report underscores the importance of public administration reform, including clarifying of the role and structure of the central administration, staff training, and strengthening of institutions involved. The need for legal and regulatory reform is also highlighted.

### **Russia- Intergovernmental Fiscal Relations in the Russian Federation, Report No. 11302-RU, December 18, 1992**

This is an early study examining the system of intergovernmental finances at all levels of government. It also reviews then existing draft legislation on intergovernmental finance. The paper addresses two important issues: fiscal sovereignty and intergovernmental fiscal dimensions of natural resource taxation.

### **Fiscal Decentralization, Studies in Economies in Transformation, Christine I. Wallich, December 1992**

The study covers topics such as intergovernmental fiscal relations, subnational finance, expenditures and expenditure assignment, the intergovernmental sharing system, and the division of revenues from natural resource taxes. It concludes that establishing an institutional framework for reform is the first priority. The second is to abolish the practice of passing the deficit down from the federal to the subnational level. Third, revenue shares and transfers to subnational governments should be scrutinized.

### **Russia and the Challenge of Fiscal Federalism, World Bank Regional and Sectoral Studies, ed. by Christine I. Wallich, January 1994**

This book is based on work undertaken as part of the World Bank's technical assistance program to Russia, which began in 1991. The team working on this project examined fiscal decentralization and intergovernmental fiscal relations between Russia and its 89 oblasts. The authors concluded that the design of a well-functioning, intergovernmental fiscal system is the key to macroeconomic stability, to structural adjustment, and to the provision of social services and a social safety net in Russia.

### **Decentralization and Fiscal Disparities Among Regions in the Russian Federation, Philippe Le Houerou, (Internal Discussion Paper-Europe and Central Asia Region), January 1994**

This paper examines the disparities among regional budgets, after the decentralization of the previous two years. It observes that the horizontal fiscal imbalances (revenue raising capacity vs. expenditures) were likely to widen across the regions. The paper suggests that the changes proposed by the government in the conceptual framework for the budget should be complemented by the (a) assignment of detailed expenditure responsibilities between the federal and subnational level of government in order to improve transparency and accountability, and (b) allotment of general equalization transfers through a formula-based grant mechanism.

**Budget Coverage and Government Finance in the Russian Federation, Philippe Le Houerou, Elana Gold, and Stanislav Katash, (Internal Discussion Paper-Europe and Central Asia Region), January 1994**

This paper demonstrates that the Russian Federation budget grossly misrepresents revenues and outlays. The paper reconstructs a more accurate and different picture, applying Western public finance concepts and definitions. It recommends a number of specific steps to redefine the budget coverage and presentation.

**The Transformation of the Regional Fiscal System in Russia – The Case of Yaroslavl, (Internal Discussion Paper-Europe and Central Asia Region), Lev Freinkman, and Stepan Titov, August 1994**

The paper looks at the transformation of intergovernmental fiscal relations from the perspective of a regional administration. It shows that there had been major changes in the way oblasts' budgets were prepared, approved, and implemented since 1990. Even though the central government continued to exert some pressure, centralization was proceeding at a rapid pace. The shift in expenditure responsibility in social sectors was conclusive. However, with respect to “national economy” expenditure items, respective responsibilities of the federal and regional governments remained murky.

**Russian Federation – Towards Medium-Term Viability, Report No. 14472-RU, October 16, 1995**

The main focus of this CEM is fiscal adjustment. Five major issues for fiscal policy reform have been identified which are tax reform, intergovernmental financial relations, enterprise support, housing subsidies, and social safety nets.

Under tax reform, the report observes that comprehensive reform is urgently needed. Relevant issues are natural resource taxation, tax exemptions, and tax arrears. The report also specifies that improving tax administration is essential. The present administration is inequitable, inconsistent, and inefficient. “Without major investment in capacity building and efficiency of revenue collection, further tax reform and improvements in tax compliance will be severely constrained. The report recommends that tax administration be strengthened by improving staff training, computerization, and tax audit capacity.”

Inter-budgetary financial relations are also reviewed. The main recommendation in this area was “to draw clear distinctions between funded and unfunded mandates in conjunction with inter-budgetary transfer procedures to ensure financing capacity.”

**Fiscal Management in the Russian Federation, Report No. 14862-RU, November 29, 1995**

The study observes that there have been major improvements in the country's fiscal picture. However, the need for more efficient fiscal management remains. Budgets have not yet adapted to the far-reaching changes brought by the transition. The report analyzes the deficiencies of the budget system and recommends ways to improve fiscal management. It focuses on two crucial features of fiscal management, namely, intergovernmental fiscal relations, and the structural, technical and institutional aspects of the budget system. In closer examination of these two, areas issues are identified and specific recommendations are made for each set of issues.

**Budget Management in the Russian Federation, (Fiscal Policy Note), June 1998**

This note looks at a set of budget management issues with a primary focus on the federal budget. The study was timed so that it could contribute to the then forthcoming discussions on the draft Code that was before the Parliament. The earlier drafts of this work were already used by the government in changing the draft Code. The note also addresses the issues of multiyear budgeting and audit.

Included is a section on budget formulation, which covers the role of the legislature in the budget process, extra-budgetary funds, budget preparation, and multiyear budgeting. The section on budget execution discusses the Treasury system and budget implementation, as well as the audit system.

The note then incorporates the specific comments on the budget Code, in detail.

**Intergovernmental Transfers Reform in the Russian Federation, Fiscal Policy Note, February 8, 1999**

This note evaluates the existing transfer system from the federal government and the government's plans to improve the system. Total transfers take up a significant share from the budget. Earlier studies revealed that the declared objectives of these transfers had not been fully achieved.

The study claims that intergovernmental fiscal relations lacked clarity in expenditure assignments. It observes that the need for reform in this area was finally acknowledged by the government, and the provisions for 1999 federal budget stipulated some changes in the transfer formula. However, there are still strong historical, institutional, political, economic, and legal constraints to rapid implementing of reforms. The note then makes recommendations for further improvements in the system that are mostly institutional. Also, the note summarizes the system applied in four countries and draws lessons from them.

**Benchmarking Public Expenditure Analysis in the Russian Federation (Fiscal Policy Note), 1999-2000**

This note reviews the changes in the size of the government, expenditure allocations, and the structural features of the evolving fiscal structure. It also examines the public expenditures in

the light of international experience. Certain specific topics are also covered, including civil service reform and defense expenditures. The note offers a number of recommendations and provides a roadmap for further public expenditure analysis.

The following observations are also made: (a) comprehensive measurement of public expenditures is not possible because of data shortcomings; (b) expenditures are not very high compared to most countries; and (c) Russia's federalist structure is not exceptionally centralized or decentralized. During transition, federal expenditures have declined and their mix changed, while the share of the subnational governments has increased.

The note suggests that civil service reform is a pressing issue. Defense expenditures are large compared to most countries. It reiterates the point made in several earlier studies that the agenda for reform in fiscal federalism and intergovernmental transfers is large and pressing.

A number of recommendations have been made referring to the need for making progress in several areas: making data improvements, providing extensive coverage, clarifying the basic role of government, eliminating the noncash economy, developing a reform strategy for civil service, and reinforcing fiscal sustainability.

**Decentralization of Regional Fiscal Systems in Russia, (Policy Research Working Paper), Lev Freinkman, and Plamen Yossifov, April 1999**

The paper examines intergovernmental fiscal relations within regions. The authors review the channels of tax sharing and local transfer schemes. They have studied data for 89 consolidated regional budgets for 1992-96. They found that while the federal government's relative role declined, the role of local governments increased substantially.

Other findings include the following: decentralization has taken place in certain type of local administration; regions near each other tend to have similar budget arrangements; fiscal decentralization seems positively related to the share of education spending; and regions with more decentralized finances have tended to experience less economic decline. The authors thought, however, that further decentralization without greater transparency could bring greater debt and deficits.

They recommend greater budgetary autonomy, more transparent intergovernmental fiscal relations, and stricter limits on total debt and budget deficits of subnational governments.

**Subnational Budgeting in Russia, World Bank Technical Paper No. 452, Lev Freinkman, Daniel Treisman, and Stepan Titov, November 1999**

The paper states that the previous reform efforts focused on changes at the federal level, and on center-region relations. Not enough attention has been paid to reforms at the subnational level. Incentives do not encourage effective tax collection and efficient allocation of public resources. Meanwhile, subnational fiscal adjustment is important to support economic growth and increase efficiency in public spending.

According to the findings of the report, the legal framework for subnational budgeting is undeveloped and controversial. Subnational governments do not have strong incentives to push

important structural reforms. The report suggests that the central government needs to use incentives through the targeted use of conditional aid.

The report observes that the recent initiatives of the government corresponded closely to the suggestions made by the authors. However, much more needed to be done. Subnational fiscal reform agenda should include clarifying subnational government functions, developing a regulatory framework, consolidating the budget, preparing the budget and managing expenditure; accelerating expenditure restructuring, managing debt, reforming local taxation, and budgeting capital.

### **Corruption in Russia (Interim Report), June 2000**

The report distinguishes three types of corruption: policy capture, administrative corruption, and judicial capture. The emphasis is put on the impact of policy and judicial capture, which are higher than administrative corruption. Therefore, an anti-corruption program that centers primarily on enforcement would not be very successful in combating corruption. Policy and institutional reforms aimed at increasing transparency and accountability in the public sector should be combined with enforcement.

### **Russia's Transition to a New Federalism, Jorge Martinez-Vazquez and Jameson Boex, February 2001**

The report covers the issues of dynamics of decentralization, expenditure responsibilities, revenue assignments and tax administration, the system of transfers, and subnational borrowing. It also focuses on the process through which reforms in intergovernmental fiscal relations should be implemented.

## Summary of Mr. L.I. Yakobson's (FCPF) comments

### Summary

The World Bank cooperation with Russia in public sector management is considered in a dual context: proceeding from the peculiarities of public sector institutions in a post-socialist economy, and in terms of comparative positions of the cooperating parties, i.e. the World Bank and the Russian Government.

The institutional changes in the public sector were among the key transition processes and that a relatively passive stance of the Russian authorities could reduce the effectiveness of the transition. So, an abstract consideration of the issue should lead to the conclusion that the establishment of modern MEPS institutions should have been a priority strategic task during the transition to the market. In countries encumbered with planned economy experience: the MEPS institutions – as compared with private sector institutions – first, are a greater novelty; second, are less likely to develop spontaneously in a successful manner; and third, have a marked influence on the development of the other sector. Therefore, the policy of considering the establishment of respective institutions as the second or third round of the reforms, which was initially characteristic of both the World Bank and the Russian authorities, was not a appropriate.

During the larger part of the period under review, both sides were inclined to focus the reform strategy on a limited number of generalized goals and universal constraints. Therefore, practically no attention was paid to strategies to reforming public sector institutions (e.g., strategies to phase in a tax administration system, or to adapt gradually the education sector to the needs of a market economy). Neither party considered the specific problems as relevant and of strategic importance. The World Bank underestimated the place of these problems on the Government's agenda, while the Government failed to pay due regard to the fact that the search for their rational solutions of public sector reform required the use of modern theory and foreign expertise no less than in the case of privatization or macroeconomic stabilization.

Under specific circumstances of the early 1990s, World Bank expertise could have been most helpful in addressing 'particular' issues, especially those related to the reform of the public sector. Neither cooperating party took that into account on a timely basis, which can be attributed not only to subjective errors [of judgment], but also to a number of objective factors. Anyway, the two sides missed a realistic chance to ensure the World Bank's productive participation in shaping important aspects of Russian reforms together with a chance of a more successful implementation of the reforms.

In later years, however, the Russian authorities started establishing a more efficient cooperation with the World Bank on specific issues of public sector development.

Regarding the projects approved in the area of public sector development, one must note an emphasis on 'technical' (administrative) rather than institutional aspects of the reforms and the desire of both sides to avoid politically sensitive issues. This is also true for fiscal policy projects.

\At the same time, the results of the World Bank projects and studies included both direct positive changes (e.g., in tax administration and law drafting) and an enhanced capacity for future changes.

**COMMENTS ON BARAN TUNCER'S EVALUATION REPORT**  
**Mr. L.I. Yakobson's (FCPF)**

This paper is based on a review of documents relating to the World Bank (WB) Country Assistance Strategy for Russia, as well as projects oriented, in whole or in part, to the support of public sector reforms in compliance with the CAS. A review of CAE reports prepared by a World Bank team led by Prof. B. Tuncer played a key role in the preparation of this paper. A thorough in-depth analysis presented in the reports made my job much easier.

In particular, projects to be reviewed were those listed in the papers produced by the World Bank team, and included, first and foremost, the Tax Administration Modernization Project, Legal Reform Project, State Statistics System Development Project, Regional Fiscal Technical Assistance Project, rehabilitation loans, Structural Adjustment Loans, and Bureau of Economic Analysis Project.

**Overview**

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At the same time, the results of the World Bank projects and studies included both direct positive changes (e.g., in tax administration and law drafting) and an enhanced capacity for future changes.

### **1. World Bank Assistance Context: Public Sector Institutions**

A planned economy is characterized by an absolute domination of the state. This well-known fact may have a dual interpretation: the public sector significantly exceeds the private sector in scale, or, in fact, the public sector has no institutions typical of market economy. For instance, in compliance with the first interpretation, a planned economy is characterized by an exceptionally high level of taxation while in compliance with the second one, taxation – as something different from an owner's income, or tribute arbitrarily collected by a conqueror – does not play a significant role in planned economy. On the face of it, the choice of interpretation is largely a terminological issue. However, this is not the case.

The bulk of theoretical provisions and empirical knowledge in modern economics of the public sector, which forms the basis, among other things, for the relevant developments by the World Bank, refer to the mechanisms of *interaction* between the state and *autonomous* economic entities. Moreover, it is usually assumed that public policy is formulated within the framework of democratic institutions. The term 'public sector' may be applied to planned economy only with a proviso that it denotes a phenomenon which is fundamentally – and not only in quantity or secondary attributes – different from the public sector in market economy.

A market economy public sector (MEPS) *occurs* rather than evolves during the transition to the market. Reduction of the *relative scale* of public economic activity within the framework of post-socialist transformation does not reflect the substance of the matter. It is the elimination of public sector constraints and establishment of the private sector rather than the redistribution of responsibility and resources between them. This is the difference from a number of reforms in countries whose economic history is not encumbered with planned economy.

Undoubtedly, there is an inherent linkage between the qualitative characteristics of the institutions and their 'coverage.' Thus, viable MEPS institutions can hardly correlate

with, e.g., an 80 percent share of the extended government budget (EGB) in the GDP; however, the mere fact that the EGB share has drastically decreased is not very informative. The response to the crisis of the welfare state included not only quantitative, but also profound qualitative changes in the MEPS operation mechanisms; however, it was changes within the MEPS framework that did not call its basic characteristics in question (formally, it corresponds to an indisputable applicability of the conceptual aspects and instruments of public sector economics to both old and new phenomena).

Public activity mechanisms under planned economy can often serve as a ‘construction material’ for the MEPS; at the same time, their existence complicates the ‘construction’ process. It is their peculiarity that they are very useful for a rapid and almost unlimited *mobilization* of resources in the context of public ownership. However, there are hardly suitable for a regular mobilization of private sector resources without an excessive damage to the economy (i.e. for taxation *per se*). It is less evident, but no less important that these mechanisms are significantly inferior to the modern MEPS in terms of *efficient allocation* of resources available to the state (see further detail in Yakobson, 1995, Ch. 1).

Unlike the MEPS key institutions, some basic private sector institutions actually existed in planned economy ‘pores.’ It refers not only to individual household plots in rural areas, but also to various legal, semi-legal and illegal activities in cities. Besides, such institutions are much more capable of spontaneous self-development than the MEPS institutions. Privatization, which means an increased range of opportunities for private economic initiative, provides for private sector development and simultaneously requires the establishment of adequate MEPS. On the other hand, efficiency of the private sector depends on the current policy though its development is guaranteed by privatization *per se*. However, it is more applicable to the policy, which directly regulates not only private, but also public sector components: e.g., not only financial market development, but also the establishment of an economically and socially adequate tax system.

So, an abstract consideration of the issue should lead to the conclusion that the establishment of modern MEPS institutions should have been a priority strategic task during the transition to the market. In countries encumbered with planned economy experience: the MEPS institutions – as compared with private sector institutions – first, are a greater novelty; second, are less likely to develop spontaneously in a successful manner; and third, have a marked influence on the development of the other sector.

## **2. World Bank Assistance Context: Bank’s Strategy and Government’s Policy**

A review of World Bank documents dating back to the early 1990s makes it clear that the Bank’s assistance strategy for Russia was largely based on interrelated (and often tacit) assumptions that, first, Russia had on MEPS; second, its qualitative improvement was less important than its quantitative reduction; and third, a successful development of the private sector was not strongly dependent on strengthening the MEPS institutions. According to the viewpoint set forth in the preceding paragraph, all three assumptions were erroneous.

It was correctly stated in Tuncer, 2001 (pp. 6-7) that the 1993 CAS paid almost zero attention to the issues directly pertaining to the functioning of the state, with the exception of references to the need of legal framework development and regional and local capacity building; such references were of a very general nature and concerned the context rather than substance of the proposed activities. The 1994 and 1995 Country Assistance Strategies slightly developed those references and added some emphasis on intergovernmental fiscal relations and tax administration. Thus, the focus on MEPS issues was quite selective and incomparably less than the focus on macroeconomic stabilization, financial sector development, or enterprise reform. In this case, we mean interpretations, views and intentions recorded in strategic documents rather than consistency and success of practical actions or relevant strategies (the latter were not very efficient, e.g., with respect to enterprise restructuring). Having no ambition to conduct an exhaustive analysis of the causes of a largely inadequate, to my mind, selection of strategic priorities, I can make the following comments. Papers pertaining to the World Bank assistance to Russia in the early 1990s indicate that the Bank's experts and, evidently, management tended:

To overly on the Bank's past experience in third-world countries, which had focused on the promotion of and elimination of unjustified restrictions on the private sector and supportive macroeconomic management;

Without sufficient grounds, to identify the assessments and intentions of Russian authorities with their own assessments and intentions, which was caused, among other things, by inadequate understanding of the role of relatively abstract long-term objectives in the Russian policy of that period.

In the late 1990s the World Bank radically revised its approaches to supporting reforms in the developing countries and increased the emphasis on qualitative improvement of MEPS institutions. In that respect, the experience on which the Bank relied trying to find precedents for its policy in Russia was disputable. It was more important, however, for Russia, first of all, to *create* a MEPS, at a stage when the institutional structure of the economy was already bearing practically no traces of even those MEPS institutions that had existed in the country in the beginning of the century (that was one of the differences between the situation in Russia and some Central and East European countries). If those institutions – even rather primitive from the contemporary viewpoint – had survived, direct reliance on precedents in the developing countries would have been justified; however, it was quite unreasonable in the absence of such institutions.

In fact, the establishment of a MEPS progressed quite rapidly in the period under review, which, strictly speaking, was vital for the economy. It was characteristic of the establishment process that, first, legal acts were often adopted without the slightest opportunity or even intention to implement them, and, second, that many institutions were being created as informal ones. For instance, President Yeltsin's Decree No. 1, which was devoted to education, belonged to the former category while many of the

institutions used by the education sector to adapt to the emerging market economy (though education largely remained a public sector) belonged to the latter category.

The establishment of a MEPS was one of the key transition aspects in Russia; due to the aforementioned considerations, it could not play a secondary role in practice. The fact that it was not included in the list of policy priorities reflected the nature of an equally rapid but less controllable development process rather than ‘freezing’ of the situation until the resolution of problems that were recognized – whether justly or not – as greater priorities.

However, it would be unfair to apply such statement to the World Bank assistance as such. The Bank’s assistance is directed to the policy of national governments in the relevant sectors rather than to the economy and its institutions per se; it affects the national policy through analysis, dissemination of information, provision of funds, and other activities. Therefore, the outcomes – both actual and potential – include, strictly speaking, only *policy modification*, a difference between what the national governments would do without the World Bank and what they do with the World Bank assistance. It is only in this area that the World Bank has a range of opportunities. To my mind, that fact is not always fully taken into account in the CAE materials.

Policy priorities stated by the Russian authorities (especially at the initial stage of transition) were generally consistent with those set forth in the World Bank documents. However, the reform leaders of that period have been recently pointing out that the essence of their policy was tactical maneuvering to prevent the imminent threats of hunger, civil war, split of elites, reinstatement of communists, etc, rather than the implementation of doctrinal priorities. This is already noticeable in Gaidar, 1996, and Yeltsin, 1994. Later publications, interviews and presentations by the active participants of those events made an increasingly stronger emphasis on the fact that they had been forced to take certain actions in the absence of any alternatives and that it had been impossible to correlate such practical actions with priorities selected a priori on the basis of conceptual considerations. To the best of my knowledge, there is a share of overstatement in these ideas, but they reflect the then dominant actual trend.

An attempt of a systemic interpretation of the trend was made in Starodubrovskaya and Mau, 2001. A reference to that book is appropriate in this case since the authors are well-informed and quite benevolent observers of the situation under review. Moreover, V.A. Mau has been and still remains a prominent member of the so-called Gaidar’s team. According to the authors of the book, weakness of the state and its institutions is a key feature of circumstances typologically similar to the Russian situation of the 1990s. Transformation is taking place “spontaneously when public authorities are weak and incapable of controlling the ongoing events and processes” (pp. 356-357, etc.). To overcome the situation it is necessary to pursue a specific policy described as 'radical' since the policy agents are characterized by ideological maximalism. However, according to the authors, a radical policy essentially consists of an utmost pragmatism and unlimited tactical maneuvering. “Ideology of radicals is, first and foremost, an ‘external ideology’ since it serves as an instrument to influence the society rather than an internal (in-house)

party means” (p. 134). Relative to the radical phase of the Russian reforms, “it was practically impossible ... to select a policy” (p. 175).

If we adopt such viewpoint, we would have to admit that:

- The establishment of new mechanisms that would allow the state to influence economic and social processes was not just a major strategic task, but was nearly synonymous with long-term strategic activities;
- MEPS establishment was not a priority for the Russian Government not because it consciously pursued other conceptually justified priorities, but because it was forced to focus on priority tactical tasks due to an objective impossibility to resolve strategic tasks.

Consequently, it would mean that:

- The World Bank was fundamentally wrong in interpreting both the objective situation in Russia and actions taken by the Government;
- Practical cooperation with the World Bank helped the Russian authorities implement tactical maneuvers in the area, which was largely outside the Bank’s field of vision, rather than influenced the development of a policy pursued by the Russian authorities.

Proceeding from the above, it is easy to explain and justify cases when the Russian counterparts were more interested in the resources that the World Bank could provide rather than in specific project details.

Available documentary evidence is not sufficient to conduct a reliable assessment of the validity of such interpretation. At the same time, there are grounds to believe that the idea of the initial cynical pragmatism of the radicals (in particular, in their relations with the World Bank) corresponds to reality no more than the idea of a strict adherence to a priori concepts (including those proposed by the World Bank).

Gaidar’s team definitely regarded knowledge obtained from Western economic literature (including World Bank publications) and their contacts with foreign experts as one of the key resources. Therefore, they were genuinely interested in concepts and proposals oriented to specific issues that were facing them. To a certain extent, this is true not only for the first years of the reform, but also for the entire period when at least some members of the team remained in the Government. However, in many cases that resource was inadequate for the resolution of practical issues. It should be noted that actions often had to be taken under stress, in an atmosphere of confusion and sometimes fear while, for political considerations, it was necessary to demonstrate confidence that the decisions were ‘scientifically justified.’

In this case, we had to touch upon psychological aspects for the following reason. If these aspects are ‘deduced’ from the actual situation, we will see self-assured pragmatists who deliberately manipulated circumstances and people, including the World Bank staff. If these aspects are taken into account, it will be easy to understand that the reformers were eager to receive recommendations that were based on foreign experience and could be applied to their everyday concerns. The point is that most everyday concerns, which were largely related to various institutional changes in the public sector, were treated as ‘tactical’ aspects of the reforms that did not require thorough conceptual thinking.

Both sides tended to identify the reform strategy with the so-called Washington Consensus. To my mind, its contents are vulnerable not because the constituent provisions are erroneous, but because of the significance attached to such provisions. Of course, basic requirements to the market reform policy are of paramount importance as *universal constraints*. For instance, a provision on macroeconomic stabilization points to a constraint that should be observed when dealing with any tax or public expenditure component. However, the provision practically does not say how to work with specific taxes or specific expenditure units.

Confining a conceptually grounded strategy to a few – though important and correct – provisions (or rather the absence of a *set of specific strategies* for various areas) turned the majority of everyday actions into ‘tactical maneuvering.’ It was not a deliberate refusal from conceptually grounded options: deliberate maneuvering of that type necessitated by political pressure took place only in few individual areas (especially in privatization). It meant that the Government failed to apply, on a timely basis, foreign concepts and experience, including those generated by the World Bank, to numerous processes which it had to deal with in practice.

For instance, there was, in principle, an opportunity to establish a tax system that would take into account – at least to the smallest possible extent – the peculiarities of the country which did not have efficient income monitoring tools; or design more or less rational mechanisms to combine paid and free education and health services. It would be incorrect to state that the authorities were generally incapable of regulating the situation with respect to these and many other issues. It is a question of an adequate control measure and instruments in view of a relatively weak state power.

In fact, interference did take place, but often not as deliberate and consistently implemented strategies. The World Bank expertise and experience of countries where the Bank had worked earlier could definitely facilitate the development of such strategies. However, the World Bank started making a meaningful contribution to the resolution of these issues in Russia mostly when the relevant negative processes had gone too far. Moreover, the processes have gained significant inertia which is sometimes difficult to overcome.

Of course, the situation was strongly dependent on the atmosphere in which the Russian Government had to work. For a long time, the Government’s opponents and the society as a whole questioned the universal constraints. Undoubtedly, it could be accounted for

by the lack of time and sometimes by the inability to formulate specific requests. Therefore, an active ‘marketing’ of technical assistance that the World Bank could offer in various reform areas would have been very useful.

The following factor was also important. A widespread perception that Russia belongs to or would very soon join the group of the most developed economies was an essential feature of the atmosphere in which the reforms were implemented (at least before the August 1998 crisis). To the best of my knowledge, even the Government leaders were not absolutely free from such illusions. An open orientation to the experience of developing countries would have been opposed by most parliamentarians in all Dumas and probably by President Yeltsin. That fact undoubtedly prevented the development of realistic strategies, especially when they required the adoption of respective federal laws.

At the same time, a number of factors required the selection of simple, even primitive options (in particular, a rather primitive tax system), which could not give the ‘ideal’ combination of efficiency and equity. These factors included: the absence of MEPS institutions and staff experienced in operating within the framework of such institutions; a relatively low level of GDP combined with a high income differentiation; heterogeneity of the society in terms of the life styles and values; inadequate respect for the law and bureaucracy which has been traditional for Russia in all historic epochs; an incomplete legal framework for business activity which is typical of the transition period, and weak law enforcement mechanisms; and a relatively large scale of organized crime and corruption.

Russia’s excessive ambitions have always complicated and are still complicating for it the use of developing economies’ experience available to the World Bank. However, an approach providing for the development of several specific strategies instead of a single ‘meta-strategy’ could probably mitigate the impact of that factor (at least in some cases). The Russian society was not – and, on the whole, is not – prepared to orient to Latin America or Asia as far as a general situation is concerned; however, even in the early 1990s it sometimes did not refuse from paying more attention to lessons learned by certain developing economies in addressing specific problems.

Finally, there were significant constraints caused by specific configurations of interests and a poor ability to curb rent seeking. In simpler terms, real policy had to be less efficient and fair than it could be without the above factor. That certainly prevented the implementation of neutral regulatory designs, but could not reduce the need for political and economic analysis of decisions and reliance on the experience of developing economies. The point is that such policy constraints are equally characteristic of many developing economies. In that case, there could have been an issue of politically correct presentation of experience; however, it would not have been absolutely unsolvable.

Conclusions of this Section can be formulated as follows. While constructing a market economy, Russia expectedly faced a great number of different institutional changes in the public sector. Such changes inevitably created challenges for the Government and were included – whether directly or indirectly – in the Government’s agenda. A desire to

remove ‘details’ from the strategy undermined the capacity for a positive impact on the developments rather than delayed changes. Of course, the Government did not have economic or political resources to ensure a rapid construction of the public sector comparable, by the efficiency and equality criteria, with the one observed in industrially developed economies. However, available resources, including the World Bank expert capacity, could have been used better.

To that end, the World Bank assistance should have followed the Government’s agenda – with its *actual diversity* – more closely. In simpler terms, the World Bank was anyway incapable of providing direct assistance to Gaidar or Chernomyrdin in their ‘principal concerns’, but it could have been quite helpful to a number of ministries when the latter were preparing (or should be preparing) critical decisions on specific public sector reform issues. In every case, it should have persistently looked for the ‘second best’, in line with specific (and very significant) distortions of the environment.

The model of World Bank assistance to Russia could have been closer to a ‘supermarket’, which energetically offers various products to purchasers, rather than to a ‘preacher’ who teaches major issues of life to the congregation. Of course, it was impossible to implement the ‘supermarket’ model as such due to economic, political and technical reasons. However, it would have been useful to start moving from the opposite extreme to that model. The process actually began in the late 1990s and is going on now. To my mind, it is a very positive fact.

### **3. Public Sector Reform Projects**

#### *3.1. Selection of Cooperation Areas*

As noted in the introduction, following Tuncer’s team approach, I focused my review on:

1. Tax Administration Modernization Project (1995),
2. Legal Reform Project (1996),
3. Bureau of Economic Analysis Project (1997),
4. State Statistics System Development Project (1999),
5. Regional Fiscal Technical Assistance Project (2000).

All these projects are designed to address issues that are really critical to the reform process in Russia. However, they are characterized by a large share of tasks relating to the technical aspects of the relevant sector reforms. Thus, 80 percent of the funds allocated under the Tax Administration Modernization Project were used to procure hardware and software. At the same time, the tax administration issues were, to my mind, excessively separated from the general issue of tax system improvement. A certain ‘technical’ emphasis is also evident in the State Statistics System Development Project though the project has undoubtedly important objectives.

The issues of intergovernmental fiscal relations and regional finance have justly played a significant role in the Bank’s assistance to Russia. To the best of my knowledge, the Bank’s experts conducted more studies specifically devoted to these issues than in any

other area of Russian reforms. While that activity definitely deserves a positive – actually, a very positive assessment, in the 1990s Russian fiscal federalism was developing under conditions where there was a lack of a consistency between the Constitution and budget legislation, and the economic capacity of the state was markedly inconsistent with the social commitments formally envisaged in the legislation.

Both features can be accounted for by the Soviet heritage and peculiarities of the political struggle and establishment of coalitions at the initial transition stage. Since the format of this report does not allow me to describe the background of that situation in detail, I will confine myself to the comment that unsettled intergovernmental fiscal relations in the 1990s allowed, among other things:

- Certain damping of social requirements through the dilution of responsibility for meeting them;
- A space for maneuvers within the framework of complicated political relations between the federal and regional authorities (intergovernmental fiscal relations were constructed, inter alia, in a way to give the federal authorities a set of instruments to exert pressure on, make differentiated concessions to, and stimulate a loyal behavior of the regions).

At the same time, interaction with the World Bank was rather based on the regulatory developments in the sphere of intergovernmental fiscal relations, with the assumption that a major task was to find ‘objectively correct’ money allocation coefficients. That work should be by no means underestimated. However, taking into account the aforementioned circumstances, prerequisites for fiscal federalism improvement in Russia include shifts that go far beyond the scope of public finance issues, namely:

- Ensuring that federal laws and federal authorities actually dominate throughout the country, which would spare the need to use budget grants as a flexible instrument to exert pressure on regional authorities;
- Bringing the legislation into compliance with available resources, which sometimes means a painful limitation of earlier stated social guarantees;
- Providing for a clear distribution of responsibilities and powers between federal, regional and local authorities in areas subject under the Constitution to joint terms of reference.

The first prerequisite has been implemented quite recently allowing initiating a gradual implementation of the two other prerequisites. Therefore, the Regional Fiscal Technical Assistance Project seems to be rather timely.

Some projects, especially the Legal Reform Project and the Bureau of Economic Development Project, created, among other things, specific opportunities that have not been directly reflected in the evaluation materials that I reviewed. These were flexible projects that allowed to finance participation by Russian top experts in the development of public sector institutional changes.

It should be taken into account that the segmentation of Russian labor markets during the period under review did not bypass the expert activity. Standards consistent with ordinary budget funding mechanisms made the state absolutely uncompetitive – relative to the private sector – as a purchaser of the services of top legal, economic and other experts. At the same time, such services were objectively necessary to prepare reforms. Under these circumstances, even EU TACIS projects were sometimes treated by Russian public authorities as sources of payment for Russian development experts. It is Russian experts that were sometimes expected to assure major project results, though the bulk of expenditures went to foreign expertise while Russian experts formally played a subsidiary role. *Ceteris paribus*, flexible and relatively inexpensive World Bank projects proved more efficient in that context.<sup>3</sup> However, such structure was generally rather artificial and hardly an optimum one.

The public sector issues were, to a certain extent, reflected in the Structural Adjustment Loans. Among other things, SAL I, SAL II and SAL III supported tax administration development activities. SAL III also addressed the issues of public expenditure administration and administrative reform.

On the whole, the selection of cooperation areas, other conditions being equal, tended to focus on:

- ‘Technical’ rather than politically sensitive reform aspects;
- Budget administration improvement rather than rationalization of the entire institutional environment of budget preparation and execution, including structural reforms in sectors financed from public funds;
- Use of the World Bank financial resources rather than expertise.; and
- For the sake of comparison, we should point out a more balanced approach used more recently during the preparation of the Regional Fiscal Technical Assistance Project, as well as in education and health projects (though the latter have been facing certain difficulties – mostly on the Russian side).

### *3.2. Project Effectiveness*

Based on the available materials, the effectiveness of the aforementioned projects can be assessed as follows.

The Tax Administration Modernization Project has led to a tangible and meaningful strengthening of tax administration capacity, first and foremost, in terms of equipment and staff qualifications. However, that capacity could have never been used to a full extent without serious institutional changes in the public finance system and economy as a whole, including tax reform implementation and, for instance, reduction of the barter share, organized crime control, etc. During the project implementation period, a gap between the proposed and actual status of such factors emerged, which evidently affected

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<sup>3</sup> Of course, it should be taken into account that the WB extends loans while TACIS projects are financed from grants.

interest in the project. Anyway, there are grounds to believe that the results of the project have been useful under the current circumstances.

The Legal Reform Project facilitated the development of a number of important laws, legal data codification, and, to a certain extent, legal education and judicial reform preparation. A positive role of the project's flexibility was noted above. However, a somewhat clearer definition of the project priorities and internal procedures might have improved its effectiveness.

The Bureau of Economic Analysis Project (BEAP) played an important role in financing and arranging for expert work on various Russian economy reform issues, including a few public sector problems. However, the sector issues were not central to the work program. The project implementation difficulties were connected with finding the best possible relationship between research – certainly oriented to practical needs – on the one hand, and policy analysis and direct involvement in decision-making, on the other. The Russian counterparts had failed to clearly define their position on the matter beforehand and changed it with time, *inter alia*, for objective reasons. In that case (similar to the Legal Reform Project), it was a manifestation of a trade-off between flexibility and clearly defined expectations.

The current implementation stages of the State Statistics System Development Project and the Regional Fiscal Technical Assistance Project do not allow a firm assessment of their future effectiveness.

The practical impact of the World Bank Economic and Sector Work on public sector management was constrained by two circumstances mentioned above. The first one is a focus on fiscal federalism in an environment where streamlining the intergovernmental fiscal relations was limited by factors outside the scope of the studies. The second one is related to the fact that decision-makers were sometimes insufficiently interested in the work of the World Bank experts. However, one should note both a generally high quality of the studies and their impact on structuring the views of Russian experts. In particular, it is largely due to the work of the World Bank experts in Russia that we now have a set of important developments and a better understanding of modern concepts in the sphere of fiscal federalism than in most other public sector areas. All that may be needed in the near future.

More recent studies (mostly those conducted since 1999) have been characterized by the diversification of study areas and a gradual improvement of the interaction between the World Bank and Russian experts.

#### **4. Conclusions**

During the period under review, the World Bank failed to fully use its capacity for a positive impact on the establishment of a MEPS in Russia. Major reasons included:

- Underestimation of the significance of the relevant problems at the initial reform stage both by the World Bank and the Russian counterparts;
- Lack of understanding between the World Bank and Russian authorities;
- The Bank's inactivity in introducing Russia to the concepts and experience of sectoral institutional reforms in developing economies;
- Political and psychological constraints.

However, World Bank projects played an important role in the development of MEPS institutions in Russia, especially recently.

In future, it would be expedient to enhance the Bank's orientation to supporting the actual agenda of the national authorities and ensuring clear and meaningful sectoral changes.

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