# PROJECT INFORMATION DOCUMENT (PID)
# APPRAISAL STAGE

Report No.: PIDA642

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|---|---|
| **Project Name** | Public Finance Management Technical Assistance Project (P122998) |
| **Region** | EUROPE AND CENTRAL ASIA |
| **Country** | Russian Federation |
| **Sector(s)** | Central government administration (100%) |
| **Lending Instrument** | Technical Assistance Loan |
| **Project ID** | P122998 |
| **Borrower(s)** | Ministry of Finance of the Russian Federation |
| **Implementing Agency** | Federal Tax Service, Ministry of Finance |
| **Environmental Category** | C-Not Required |
| **Date PID Prepared** | 03-Jan-2013 |
| **Estimated Date of Appraisal Completion** | 14-Jan-2013 |
| **Estimated Date of Board Approval** | 25-Jul-2013 |
| **Decision** | |

## I. Project Context

### Country Context

During the decade from 1999 to 2008 sound fiscal management, strong macroeconomic fundamentals, and a favorable external environment enabled the Russian economy to grow at an annual rate of about 6.9 percent, and most Russian citizens enjoyed improvements in income and living standards. Unemployment reached a low of 5.4 percent and the poverty rate was nearly cut in half from 2002 to 2007, bringing better lives to 12.5 million people. The Russian Federation advanced to become a top-ten world economy in dollar GDP, current account, and federal budget surpluses. International reserves peaked at USD 584 billion in August 2008, the third highest in the world.

The impact of the 2008-2009 global financial crisis on the real economy was swift and deep: the decline in global demand, collapse of oil prices, reversal of capital flows, and tightening of credit triggered a sharp slowdown of the Russian economy in the fourth quarter of 2008, followed by a severe contraction in 2009 across all sectors. With the sudden reversal in capital inflows and difficulties in access to financing, Russian banks found themselves in a vulnerable position. The social impact of the crisis was also significant: rising unemployment, falling incomes, and higher poverty rates. Simulations of the impact of the crisis indicate that the number of poor people reached almost 25 million, up more than seven million from the pre-crisis normal growth scenario.

Strong pre-crisis macroeconomic fundamentals and a quick and massive policy response prevented a systemic banking crisis, liquidity crunch and currency collapse. Following a real GDP drop of 7.8 percent in 2009 the Russian economy grew steadily in 2010 (4.0%) and 2011 (4.3%) and the economy returned to the pre-crisis peak towards the end of 2011. In 2012, Russia's real GDP is expected to exceed US$2 trillion. The current account looks strong and the Central Bank of Russia added again to its stock of foreign reserves. Employment returned to pre- crisis levels even earlier than output, and wages grew at a solid pace both in 2011 and in the first half of 2012. The fiscal balance returned to a surplus and Russia's public debt was no more than 10 percent of GDP.

While the achievements of the twin-surplus economy are impressive, a fair share of the recent accomplishments was tied to high oil prices; and recent economic news has been less encouraging. A challenging external environment and worsening sentiments among businesses and consumers translate into weak growth prospects. Excluding the crisis years of 1998 and 2009, growth in 2012 is set to decline to its lowest rate in a decade and a half. Domestic demand, the main driver of the Russian economy growth, has weakened and growth is projected to decline to 3.5 percent in 2012 and to 3.6 percent in 2013. Even such growth is at risk should the euro area and the global economy fail to improve, or oil prices recede from their recent highs. With businesses struggling to fill vacancies, capacity utilization approaching pre-crisis peaks and oil prices projected to remain flat, new growth momentum will be difficult to materialize.

The weak outlook means that strong policy action is essential to reinvigorate the economy. First, economic policies will need to ensure stability. Second, Russia will need to build buffers against external volatility. This would involve replenishing the reserve fund, moving towards inflation targeting and strengthening banking supervision. Finally, government policies will need to stimulate the growth potential of the economy; raising productivity and competitiveness; diversifying the economy; and improving transport connectivity in line with its longer-term economic policy goals. Making headway on this agenda will enable Russia to boost growth above 4 percent.

Slower economic growth, long term decline in oil and gas revenues and an ageing population are expected to put the budget under increasing pressure. Therefore the need to improve productivity and effectiveness in the public sector will also be essential for Russia’s continued economic growth and fiscal stability.

## II. Sectoral and Institutional Context

Over the past few years the Russian Federation has undertaken significant public financial management and institutional reforms, incorporating good international practice and laying the foundations for a modern public finance management system. The most notable achievements include: (i) the successful implementation of a modern Treasury Accounting System and a single treasury account; (ii) the regulation of the overall budget process and introduction of three-year federal budgets; (iii) the creation of the Oil Stabilization Fund; (iv) the reform of regional fiscal relations and

the establishment of fiscal rules for the sub-national government; and (v) the modernization of the tax administration leading to a cultural shift from the traditional command-and control-approach to a modern service oriented approach.

Notwithstanding these reforms, revenue shortfalls across all government levels, inefficient budget spending, weak investment in public infrastructure modernization, and rigid financial management models in public institutions hamper the government's ability to pursue an effective fiscal and economic policy. These problems are especially acute at the regional and local levels, where they are exacerbated by a weak revenue base, under-funded mandates and widely different levels of public finance management capacity across regions and municipalities. The challenges of improving the efficiency of revenue and expenditure management are not new, but they have been exposed and aggravated by the financial crisis. The proposed technical assistance (TA) to the Ministry of Finance (MOF) and the Federal Taxation Service builds on a long history of cooperation with the Bank in the areas of budgeting, tax policy and tax administration. Strategic directions for change have already been laid out by the Government in policy documents on tax policy and administration, budget effectiveness, inter-budgetary relations, and e-budget.

Tax Policy and Administration: The Government has already carried out a broad range of tax reforms and modernization of tax administration which have transformed the tax system. Having carried out the obvious major tasks, Government is now left with a range of more complex tax issues, where they would like to benefit from international best practice, covering both policy and related administration aspects. The objectives are to improve the fiscal balance over the medium term, create incentives for restructuring of the economy, increase fairness and improve the efficiency, effectiveness and user friendliness of tax administration.

Government has set out strategic directions for change in the “Main Directions of Tax Policy of the Russian Federation for 2011 and the Planning period of 2012 and 2013”. Based on this document, the Ministry Finance focuses on:

(a) reforming oil and gas taxation regime;
(b) implementing new transfer pricing policy, broadly in line with the OECD’s Transfer Pricing Guidelines
(c) introducing more systematic and rigorous analysis and to examine the feasibility of publishing information on tax expenditure with the annual budget;
(d) Harmonization of VAT and excise within the customs union with Kazakhstan and Belarus;
(e) review legislation and amend the tax code where necessary in the areas of: (i) financial sector taxation, especially those related to complicated financial transactions like derivatives; taxation of non-hydrocarbon minerals, and (iii) provisions in double taxation avoidance treaties relating to beneficiary ownership of income;
(f) revise small and medium enterprise taxation regime so that it facilitates SMEs meeting their tax liabilities but prevents abuse of the system;

The FTS continue its efforts to improve effectiveness of taxpayer services. Recent customer services initiatives, including e-registration and telephone call centers, the range of services is limited and taxpayer awareness is low. Government plans to upgrade taxpayer services through training of FTS staff in a more client-friendly approach, upgrading information systems and outreach to taxpayers.

Although the current appeal and review mechanism has helped reduced the number of cases going to higher courts, taxpayers’ perceptions of the fairness of the tax dispute resolution system (non-court appeals) are poor. For this reason FTS plans to review the dispute resolution system and improve tax official skills in mediation with the objective of attract more taxpayers to use the internal appellate system rather than go to the courts.



Intergovernmental fiscal relations and sub-national PFM: With 83 constituent regions which vary widely in population, geography, economic development, and natural resources, the Russian Federation confronted serious issues of intergovernmental fiscal relations in the late 1990s. The legal framework for fiscal federalism was deficient, numerous federal mandates for sub-national governments were unfunded, revenue and expenditure responsibilities between different levels of governance were unclear, equalization transfers did not exist both at the federal and regional levels, and regions with strong lobbying powers enjoyed special treatment from the federal authorities. The government initiated a series of programs to introduce more order and symmetry into the system of fiscal federalism in 1999-2001 and again in 2002-2007. As a result, unfunded mandates were transformed into targeted subventions to the regions, a more transparent system of the federal and intraregional transfers was created giving priority to equalization transfers, and clear revenue and expenditure assignments were established for different levels of government. However, over time deficiencies in the system have become apparent. The number of transfers with unclear outcomes has expanded and currently there are more than 110 federal transfer windows. Many of these are too small to achieve their intended results, and their results are not properly evaluated.

Over the past several years federal and sub-national authorities have taken actions to improve public financial management (PFM) system at sub-national level. Many sub-national governments have adopted three year budgets and the Treasury system is operating at sub-national level. However, the quality of PFM varies widely across regional and municipal governments of the Russian Federation. According to the Ministry of Finance’s measurement system 20 out of 83 regions have poor quality PFM. The federal authorities are committed, under The Concept of Inter-budgetary Relations and Organization of the Budget Process in RF Subjects and Municipal Entities Until 2013 to undertake new reform steps. The new Program on Enhancing the Efficiency of Budget Spending to 2016 will extend program budgeting principles, public expenditure efficiency programs, innovations in service delivery and anti-corruption measures to regional and municipal government.

E-Budget: The Ministry of Finance sees improvements in information management as critical to the achievement of its objectives of improving efficiency, effectiveness and transparency of public finances. An automated treasury system (FTAS) has been fully operational in 83 regions since September 2011 and a web-portal, providing access to FTAS, is being rolled out to nearly 35,000 spending units during 2012. The E-Budget program represents the next stage of systems development and integration. The development of E-Budget (an integrated information system for managing public finances) was initiated in July 2011 . According to the Ministry of Finance (MoF) Order No. 433 of October 24, 2011, the Operator of the e-Budget system is the Federal Treasury (FT) and a Project Charter prepared by the MoF presents the main objectives, activities and implementation arrangements, with defined roles/responsibilities and risk mitigation measures.

Budget Efficiency, Transparency and Sustainability: Government has made significant progress towards improving budget efficiency and sustainability. Notable achievements have been better regulation of the overall budget process, treasury system implementation and treasury single account, use of three-year rolling budgets; the creation of the Oil Stabilization Fund and the establishment of fiscal rules for sub-national

governments. These reforms played a significant role in helping Russia to weather the 2008-09 financial crisis.

Government has begun a series of new initiatives with the aim of further improving budget sustainability, expenditure efficiency, and creating incentives through the introduction of new transparency, accountability. These policy directions are described in the Concept of Long-term Social and Economic Development of the RF, in the Program on Enhancing the Efficiency of Budget Spending, Presidential budget addresses to the Federal Assembly in 2011 and 2012 and other policy documents. The Ministry of Finance top mid-term priorities include programs to:

(a) improve medium and long term budgeting and use of fiscal rules
(b) finalize introduction of program budgeting and approve the 3-year budget, based on program classification, starting with the 2014-2016 budget;
(c) introduce innovations in service delivery to allow participation of non-state organizations in service delivery but ensure adequate accountability mechanisms to ensure that public funds are managed efficiently and effectively;
(d) enhance budget planning for public procurement and management of non-tax revenues;
(e) reform internal budget control and introduce internal audit;
(f) introduce financial reporting for the public sector using on new accounting standards based on IPSAS



## III. Project Development Objectives

To improve transparency and results focus in public financial management and build institutional foundations for improved budget efficiency, effectiveness and accountability.

## IV. Project Description

**Component Name**

Improving the Economic Efficiency of Tax Policy and Tax Administration

Modernizing the System of Inter-Governmental Fiscal Relations and Sub-National PFM

Support for the Development of E-Budget System

Budget Efficiency and Sustainability

Project Management

## V. Financing *(in USD Million)*

| For Loans/Credits/Others | Amount |
|---|---|
| Borrower | 83.57 |
| International Bank for Reconstruction and Development | 50.00 |
| Total | 133.57 |



## VI. Implementation

The Ministry of Finance will have overall responsibility for the implementation of the project. Other implementing Agencies are the Federal Tax Service and the Federal Treasury. Project implementation arrangements are designed to ensure the efficient management of the project and to facilitate inter-departmental coordination within the MOF and between the MOF and other stakeholders. Project implementation will be carried out primarily by operational managers as part of their work program. Coordination between related activities will be managed by four Technical Groups and a Project Working Group (PWG) will coordinate the strategic level decision making process. The PWG will be led by the Deputy Minister of Finance, and include high level representatives of the relevant ministries, departments and agencies. It will set priorities for the reform, exercise supervision over implementation of the reform program and makes decisions with respect to the nature, consistency and type of technical assistance to support the reform.

The Minister of Finance has appointed a Deputy Minister as Project Coordinator. The Project Coordinator will provide overall direction and management of technical and policy aspects of the project and ensure compliance with World Bank project management requirements.

The MOF has decided to appoint a Project Implementation Unit to help ensure that the Ministry adheres to the procurement, financial management and disbursement procedures as set out in the Loan Agreement and the Project Operational Manual (POM).

## VII. Safeguard Policies (including public consultation)

| Safeguard Policies Triggered by the Project | Yes | No |
|---|---|---|
| Environmental Assessment OP/BP 4.01 | | X |
| Natural Habitats OP/BP 4.04 | | X |
| Forests OP/BP 4.36 | | X |
| Pest Management OP 4.09 | | X |
| Physical Cultural Resources OP/BP 4.11 | | X |
| Indigenous Peoples OP/BP 4.10 | | X |
| Involuntary Resettlement OP/BP 4.12 | | X |
| Safety of Dams OP/BP 4.37 | | X |

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|---|---|---|
| Projects on International Waterways OP/BP 7.50 | | X |
| Projects in Disputed Areas OP/BP 7.60 | | X |



## VIII.Contact point

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